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REVIEW OF THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983, IN ITS ATTEMPT TO PROMOTE BANK SAFETY AND SOUNDNESS THROUGH A STRENGTHENED COUNTRY RISK EVALUATION PROCESS, INCREASED BANK CAPITAL, ENHANCED DISCLOSURE OF LDC LENDING, AND SPECIAL RESERVES FOR VALUE IMPAIRED INTERNATIONAL DEBT. IT ALSO SOUGHT TO REDUCE INCENTIVES FOR RISKY INTERNATIONAL LENDING BY LIMITING WINDFALLS FROM HIGH FEES CHARGED IN RESTRUCTURING AGREEMENTS

JUNE 25, 1986

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REVIEW OF THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983

WEDNESDAY, JUNE 25, 1986

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Hecht, Proxmire, and Sasser.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. The subcommittee will come to order.

Today our subcommittee will examine the progress made since 1983 in implementing the International Lending Supervision Act which I and Senator Proxmire originally introduced in that year. The Heinz-Proxmire bill was introduced at a time when banks were dangerously exposed to a group of less-developed countries [LDC] debtors suddenly unable to pay their debts. Congress was being asked to fund an $8.5 billion contribution to the International Monetary Fund to hold the international financial system together. Our legislation was intended to ensure that the banks did not get a free ride and would be more likely to make sensible LDC lending decisions in the future.

The act attempted to promote bank safety and soundness through a strengthened country risk evaluation process, increased bank capital, enhanced disclosure of LDC lending, and special reserves for international debt already gone bad. It also sought to reduce incentives for risky international lending by limiting windfalls from high fees charged in restructuring agreements. Those of us who crafted the legislation hoped that with proper implementation it would help to relieve the danger of an international financial crisis. Today we are undertaking our first review of the legislation to assess its impact on bank safety and, just as importantly, to see what progress is being made on the underlying LDC debt burden, which is the source of bank problems.

Without question, regulation of international lending has changed since Heinz-Proxmire was passed, and there are signs of progress in reinforcing bank safety.

A review of bank capital indicates U.S. banks have increased their capital by half since 1982 while LDC lending has remained fairly constant. As we see in chart I (see p. 4), there has been an improvement in the ratio of bank capital to LDC assets. However, we will want to hear what specific efforts have been made to increase capital because of heavy LDC exposure.

New disclosure requirements have increased information available on LDC lending. However, I think we will be interested to hear whether the current threshold for detailed country lending reports of 1 percent of assets or 20 percent of capital, whichever is less, are sufficient.

Rapidly increased bank recognition of nonperforming loans and loan chargeoffs could also be viewed as evidence of the success of Heinz-Proxmire. Chart II (see p. 5), shows a doubling of problem loans and a tripling of chargeoffs over the last 4 years at a time of roughly constant exposure to the LDC's. Heinz-Proxmire called for bad debts to be openly recognized and specific reserves set aside.

However, the regulators have rated only a handful of countries value impaired requiring special reserves, and these are countries that are absolutely dead in the water. I don't think you have to be a regulatory genius to recognize the need to reserve for Poland. We look forward to hearing whether the recognition of bad LDC debt is being aggressively undertaken.

Even if Heinz-Proxmire has increased bank safety, there continues to be real problems for both the banks and the LDC debtors. United States banks hold $90 billion of debt to the major 15 debtors—$25 billion to Mexico alone—and almost none of it subject to special reserves. If classified, it is in the other transfer risk or substandard categories for which the regulators apparently require no particular action by banks. Moreover, where banks reserve for loans or write down loans, none of the benefit passes on to the troubled debtors in the form of reduced debt burden.

Ultimate resolution of the debt problem for the banks involves resolution of the debt problem for the debtors. Assisting the debtors is not a matter of altruism, as we see in chart III (see p. 6). Export sales to developing countries have been relatively level over the last 5 years, but where the less developed countries are concerned—the purple bars—and where the Latin American exports are concerned, we are at a substantially lower level today than we were 5 years ago, and it's true both for LDC's in general and it is particularly true for Latin exports, and if Latin exports were where they had been in 1981 we would be as a nation exporting more today than we were in 1981, rather than less.

I would argue, as the evidence clearly shows, that the future of U.S. trade depends in large part on healthy LDC markets. They account for nearly two-thirds of our exports and our exports will never fully recover if those countries do not recover.

As Secretary of the Treasury Baker points out, the countries themselves must take the initiative and reform their economic policies if growth is to resume. But they also need the support of their creditors, and it is an open question what form that support should take. Secretary Baker calls for additional lending. Critics of his plan say that debt relief is essential.

Under any circumstances, some writeoffs and debt relief will occur. Some banks are writing down LDC loans now, while others are swapping debt for equity. Some LDC's have limited interest payments while others talk of paying interest in local currency. It's conceivable that some of these innovations may usefully assist LDC recovery. Certainly all will hit bank earnings and the attitude of regulators to new loans and new variations will be crucial. We look forward to hearing from both our panels about the merits of these approaches and the best way to handle them.

Let me just observe that so far I haven't found anybody who has the answer and I suspect there are no easy answers to these questions. The Baker initiative or any alternative approach will be complex because that is the nature of the LDC debt problem. So today we hope to begin to understand better how the continuing problem of troubled LDC loans can be addressed in a way that ensures responsible participation by the banks while best protecting the safety of the banking system.

[The following charts were submitted for the record:]

CHART I

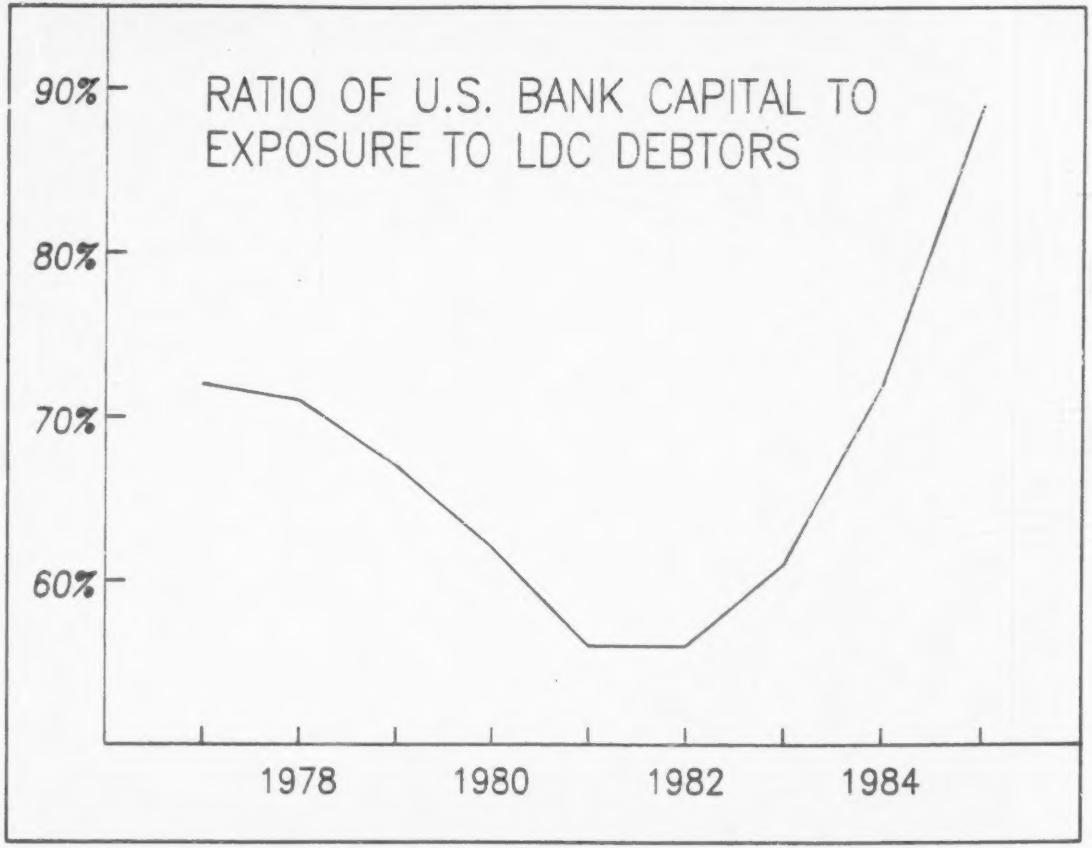

RATIO OF U.S. BANK CAPITAL TO
EXPOSURE TO LDC DEBTORS
90%
80%
70%
60%
1978
1980
1982
1984

CHART II

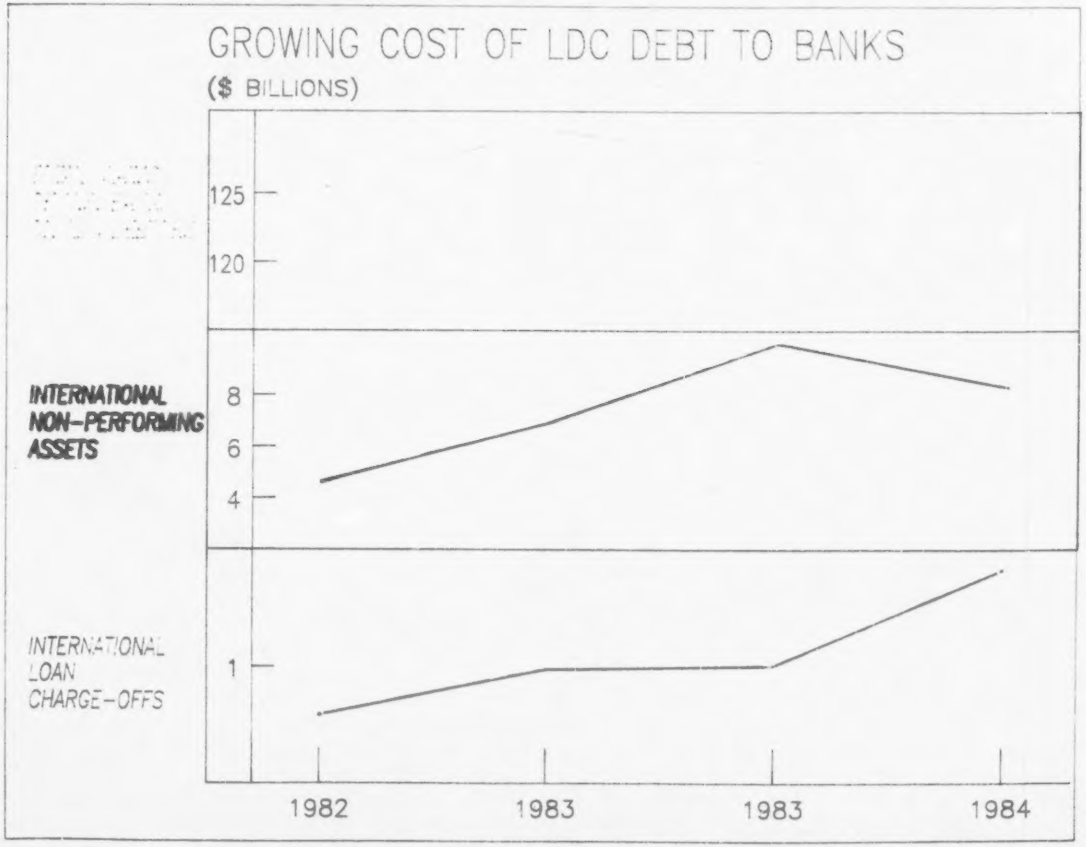
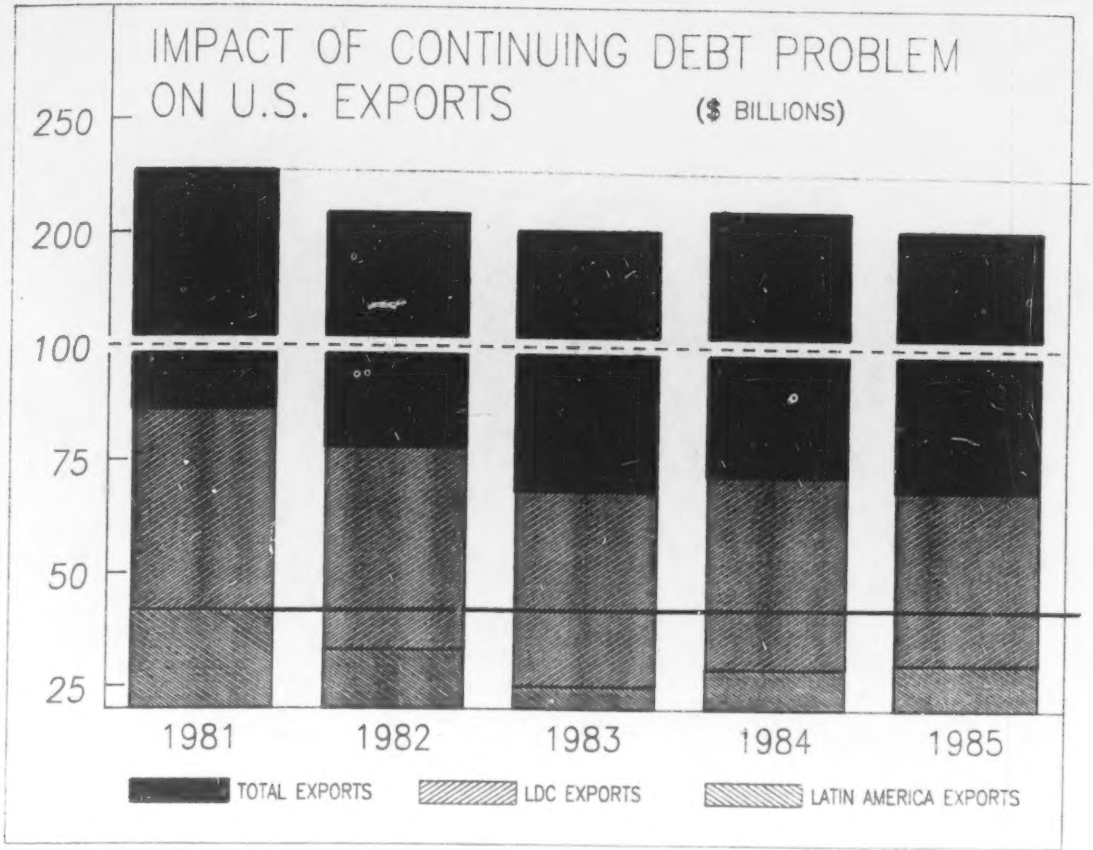

GROWING COST OF LDC DEBT TO BANKS
($ BILLIONS)
125
120
INTERNATIONAL NON-PERFORMING ASSETS
8
6
4
INTERNATIONAL LOAN CHARGE-OFFS
1
1982
1983
1983
1984

CHART III



IMPACT OF CONTINUING DEBT PROBLEM ON U.S. EXPORTS ($ BILLIONS)

Senator HEINZ. At this point, before asking our witnesses to proceed, I want to recognize the ranking minority member of this subcommittee without whose aid, help, and great knowledge we would never have been able to write the legislation on which we are having oversight hearings today, my friend and colleague, Bill Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman. I have never heard you more eloquent. I very much appreciate especially your closing remarks and your constant reference to Proxmire-Heinz.

Mr. Chairman, this is the third in a series of hearings that we have had to review international debt problems. In our first hearing Secretary Baker told us the United States has in place a viable strategy to deal with the international debt problem. That strategy involves three basic elements: One, economic reforms in the debtor nations; two, increased lending by the World Bank and other multilateral financial institutions; and three, over $20 billion in new loans over the next 3 years by the commercial banks who already have more Third World debt on their books than they know what to do with.

During our second hearing Secretary Baldrige, speaking for himself and not the administration, indicated that he had serious doubts about the basic concepts underlying the Baker plan. He said the commercial banks should be writing off the troubled debt over a period of years and recommended that bank regulators permit the banks to do that, rather than insist they take a full hit to their books all at once. He was extremely pessimistic about putting new loans into these countries, noting that more than 50 percent of new money lent to the debtor nations leaves almost immediately in the form of capital flight.

Senator Bradley testified at that hearing as well. He also said he believed that the Baker plan could not work. He called for debt and interest rate relief for the debtor countries. Senator Bradley agreed that capital flight made a policy of putting new loans into the LDC's a very questionable strategy, at best.

We come back to the fundamental question surrounding the international debt problem, that is, whether it's a liquidity crisis or whether it's a matter of debtor insolvency. In a liquidity crisis a debtor may temporarily be strapped for cash, but is still creditworthy and may actually work himself out of his difficulties if banks make new loans to him. In a situation of insolvency, recognition must be given to the fact that at least some of the debt is bad and will never be repaid. Up until now the U.S. Government has analyzed the debt problem as a liquidity problem and thus we find Secretary Baker calling on the commercial banks to make even more loans to the debtor nations. I am concerned that such a strategy ends up compromising the objectivity of our bank examiners in realistically evaluating the loans already on the books of our banks. This could in the long run jeopardize bank safety.

This administration is a great believer in the free market and so am I. What does the market tell us about the worth of various LDC loans presently on the books of our banks? Press reports indicate that the market has discounted their value. Such reports tell us that a secondary market has developed in this debt and the debt of different countries is discounted by various amounts from its face value. If that is what the market is telling us, and if the banks themselves are selling the debt for less than its face value, then why shouldn't the regulators compel the banks to recognize reality and build reserves against such loans? I am anxious to hear the regulators explain their reasoning on this issue.

In passing the International Lending Supervision Act of 1983, we directed the bank regulators to force banks to increase their ratio of capital to total assets. Now I understand that certain banks are complaining that such a requirement makes it more difficult for them to maintain the flow of new funds to debtor nations called for by the Baker plan. I hope we will find out today that the regulators are not compromising on this issue, but we can understand why they might feel some conflict of interest on the matter.

If the regulators realistically evaluated the assets of our money center banks, they might be less anxious to have such banks expand interstate by buying out other troubled banks in Texas and Oklahoma. Why should we risk further destabilization of our money center banks by consolidating even more bad loans in their portfolios? The regulators' bill proposing to do this doesn't make sense and here's a Senator that's going to oppose it. In relation to this issue, I certainly hope there is no truth to the article that appeared in the October 3, 1985, edition of the New York Times that said the administration might be able to persuade the money center banks to make new loans to the LDC's by offering as a quid pro quo to support new bank powers and the removal of some of the barriers to interstate banking.

One final word. It has been my hope that at today's hearing we would hear not only from the regulators but from bank analysts, investment bankers, and others familiar with current market developments in bank stocks. I am sorry to note that although many such persons were invited, none could be here. Staff heard comments such as they want to "lie low" on this issue, or "they wouldn't touch it with a 10-foot pole." If Congress is to help the administration make wise public policy on this issue, we need to hear from people with the knowledge of what is going on in the market. I hope we will be able to penetrate the conspiracy of silence presently surrounding the matter in the banking community.

Thank you, Mr. Chairman.

Senator HEINZ. Senator Proxmire, thank you. I appreciate your kind words on behalf of the Heinz-Proxmire bill. In any event, if it wasn't for that legislation, whoever wanted to claim first authorship of it, we wouldn't have what little information we have now.

Senator PROXMIRE. The way you put it, let's make it the Heinz-Proxmire Act.

Senator HEINZ. Right. I have statements from Senators Mattingly, Dixon, and Sasser, that are to be inserted in the record.

[The statements of Senators Mattingly, Dixon, and Sasser follow:]

OPENING STATEMENT OF SENATOR MACK MATTINGLY

Senator MATTINGLY. Mr. Chairman, you are well aware of my interest in the issue of developing country debt. The 1982 international debt crisis has never been resolved and, it appears, is actually returning to the crisis point. Last November I joined with Senator Bradley and others to introduce S. 1866, a bill to establish U.S. policy on exchange rates and developing country debt. We attempted, in that legislation, to address two areas that had been the subject of much discussion, but very little action or organization. I am particularly concerned about the impact of enormous Third World debt loads on this country's trade performance. As I have pointed out in this and other committees, it is our own best interest to support the revitalization of the developing nations' economies. These countries can provide enormous market opportunities for U.S. goods and services.

I have been encouraged by the aggressive treatment of developing country debt advocated by Secretary of the Treasury Baker. However, at the same time, I have remained conscious of the continued vulnerability of U.S. commercial lenders in this regard. We can perhaps thank the International Lending Supervision Act [ILSA] that the current situation is not worse than it is for these commercial lenders. Mr. Chairman, let me close by saying that I am looking forward to learning more today about alternatives being pursued by lenders with developing nation exposure and assessments of the operation of ILSA.

OPENING STATEMENT OF SENATOR ALAN J. DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the International Finance Subcommittee of the Senate Banking Committee begins its examination of the International Lending Supervision Act. I look forward to hearing the testimony of each of the distinguished witnesses gathered before the committee today.

As you know, in 1983 Congress passed the International Lending Supervision Act [ILSA] as part of the legislation increasing the U.S. commitment to the IMF by almost $8.5 billion. This act was designed to promote sound decisionmaking in foreign lending by U.S. banks.

To some extent, it has been successful. It is impossible, however, to expect this legislation to cope with the situation that faces us today. Mexico exemplifies the current crisis. Its debt problems have grown worse since enactment of the ILSA, which means that the risks for U.S. banks are even greater than they were then. Even major new initiatives like the Baker plan do nothing more than buy a bit more time. While further improvements in regulation of international bank lending may be appropriate, what is really needed is a comprehensive approach to the overall debt crisis. We can no longer afford to focus on relatively minor parts of the problem, while ignoring the fundamental nature of the risks to our banking system and to the international monetary system that we are facing.

I look forward to learning more about how the ILSA has worked over the past few years and to working with my colleagues in an effort to determine how to address the more basic issue of the debt crisis.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. The International Lending Supervision Act has made a significant contribution to the safety and soundness of U.S. banks. Today's hearing will give the committee a more specific understanding of the regulatory changes that have taken place, and whether improvements are necessary.

We passed ILSA in 1983 in connection with the increased contribution to the international fund, both of which were enacted in response to the rapidly declining ability of less developed countries to repay their loans. Today we are going to review the effectiveness of the lending supervision provisions, and I think we should pay special attention to the debt problems that remain to be addressed through this ILSA and other means.

It's important to focus on the International Lending Supervision Act in connection with Latin American debtors in particular. Their debt problem is somewhat distinct from other LDC debt because of the nature of their borrowing history: while economically troubled countries on other continents had borrowed largely from multilaterial lending institutions at concessional rates, the oil-producing states of Latin America had borrowed in the private sector at the sky-high market interest rates prevailing during the 1970's.

I think our approach to the problem in 1983 was the correct approach: ILSA instituted a number of regulatory reforms designed to enhance bank safety and soundness. Increases in capital, special reserves, improved country risk assessments, and expanded disclosure requirements have strengthened the banks' position relative to the potential threat. The requirement that banks amortize restructuring fees over the life of new loans has reduced the attractiveness of piling debt upon debt.

We did not expect that the International Lending Supervision Act would, even with the IMF increase, resolve the LDC debt crisis. And indeed it has not. Latin American debt remains at $380 billion. These countries simply cannot grow out of debt in the immediate future. Take Mexico as an example. $100 billion of the $380 billion is Mexico's share of the debt. The prospects for simply growing out of that debt are dim: it would take an additional million jobs per year for Mexico to employ the new entrants coming into its work force. Currently in Mexico, the ratio of debt to gross domestic product in Mexico is 60 percent, for an economy to function, the traditional rule is that the debt-to-GDP ratio should not exceed 20 to 25 percent.

I think it's important to look at these realities in a straightforward way. Many European financial experts have declared much of the LDC debt uncollectible. According to one estimate, one-third of the $380 billion regional debt will have to be written off over the next 10 years. European banks have been responding to this advice for years in a graduated, incremental fashion.

I think these hearings ought to address whether the ILSA can be constructive in providing a framework for further reducing the threat of LDC debt to U.S. banks. It may also be that the financial accounting standards board statement No. 15, used for agriculture and energy banks, could provide a useful model for dealing with continuing problems.

Mr. Chairman, the banks themselves have recognized the dangers of adding massive additional debt burdens on the LDC's. Their response to the Baker plan has been subdued at best. As for the role of the World Bank in the plan, I certainly applaud the stated objective of restructuring the debtor nations' economies, but I am very much concerned about the direction some of this so-called restructuring may take.

I have referred before in this committee to the Argentinian restructuring which consisted in large part of removing all taxes on agriculture exports, resulting in a dramatic increase in Argentinian world market share in soybeans. As my colleagues are acutely aware, the fact that Tennessee's No. 2 cash crop is soybeans is the basis of my experience in this area. It was the No. 1 crop in my State until world markets were flooded by Argentinian exports.

And it is not just Tennessee soybean farmers who have been devastated by Argentinian restructuring. This committee also needs to be aware of loans such as the one to Brazil for the express purpose of setting up an agriculture export subsidy program. It is difficult to imagine supporting any program that funds foreign export subsidies in competition with our own agricultural sector.

In the final analysis, the more these countries are encouraged to flood world commodity markets, the less return they—and all farmers—receive on their exports as well as their domestic sales. Subsidies of foreign agricultural exports, therefore, are self-defeating.

Why has this policy gone forward? As we have discussed here and in the Finance Committee before, the immediate need for hard currency is the impetus for expansion of debtor nations' farm exports: since they cannot restructure their entire economies overnight, away from single-industry economies built on oil or agriculture to diversified economies, debt pressures force them to turn to quick sales of available commodities. Long-term restructuring will take time. And it will be in our interest to support that process, since Latin America has been a prime buyer of U.S. goods and services and can be again. Their indebtedness and weakened economic condition harms us in a number of direct ways.

But for the short term, the first priority must be to reduce the LDC's need for external infusions of capital, primarily by steming capital flight. Other, additional means of reducing the need for foreign capital may also be appropriate. I believe the International Lending Supervision Act can be a useful tool in seeking creative solutions.

Senator HEINZ. I want to welcome our panel witnesses: Mr. Taylor who is here on behalf of the Federal Reserve System; Mr. Bench who is here on behalf of the Comptroller; and Mr. Collier, on behalf of the FDIC.

Let me ask Mr. Taylor to proceed.

Mr. TAYLOR. Thank you, Mr. Chairman.

[The prepared statement of Mr. Taylor follows:]

STATEMENT OF WILLIAM TAYLOR, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I appreciate the opportunity to testify before this Subcommittee today to discuss the impact the International Lending and Supervision Act of 1983 has had on international lending practices. The Subcommittee has requested our views on whether the Act has been an effective mechanism in strengthening regulatory and banking practices regarding international lending. This is an important topic in light of the obvious lessons of the past as well as of the continuing problems some countries are having servicing their external debt and the need to put in place constructive and cooperative solutions to those problems. The initiatives that are now being undertaken to assist developing countries to establish an economic framework that enhances investment opportunities, encourages savings, and ultimately strengthens the countries' capability to attract capital and maintain servicing of debt are particularly important to the achievement of a longer-term solution to the international debt problem.

My testimony will focus on the three broad areas the Subcommittee has identified as of most concern: the effect of the Act on international lending practices and the international debt situation, any recommended changes to the Act and additional problems that need to be resolved.

EFFECT OF THE INTERNATIONAL LENDING AND SUPERVISION ACT ON LENDING PRACTICES

The International Lending Supervision Act set out to achieve the goal of assuring that the financial health and

stability of the United States banking system would not be adversely affected or threatened by imprudent lending practices or inadequate bank supervision. This goal was to be accomplished by strengthening bank capital, by improving the bank regulatory framework and by encouraging better coordination among international bank regulatory authorities. Although we continue our efforts in all three areas it is my view that significant progress has been made. Primary bank capital, including loan loss reserves, has increased beyond the minimum guidelines set by the bank regulatory agencies. Discipline in international lending has been reinforced not only by implementing the mandated regulations concerning reserves, accounting for fee income, and reviewing bank originated loan evaluations but also by enhancing regulatory oversight over transfer risk, instituting more frequent examinations of large banks, and conducting periodic meetings with boards of directors to reinforce examination and supervisory assessments.

Perhaps the most dramatic progress made since the passage of the Act has been in the area of capital adequacy. The Act required the federal bank regulatory agencies to ensure that banks achieve and maintain adequate capital. Since year end 1983 the capital of the nation's ten largest banking organizations has increased by almost 20 percent. Since year end 1981 primary capital for this group increased by more than 50 percent. In dollar terms the figures are equally impressive, with a total of over $25 billion having been issued by this group since 1981. Although not as dramatic, substantial increases in primary capital have been achieved by the regional banks, and the average primary capital ratio of the fifty largest banking organizations in this country is well above the minimum required by the regulators. Capital augmentation in the banking system continues, and almost all banks with high loan exposures to developing countries have raised primary capital significantly relative to those exposures. The attached chart displays graphically the progress made in reducing loan exposure to non-OPEC developing countries relative to capital for the nine money center banks and fifteen other large banks. At the beginning of the debt crisis in June 1982, exposure of the nine money center banks to non-OPEC developing countries represented 227 percent of combined capital. As of December 1985 this exposure relative to capital had declined to 140 percent. The progress made by fifteen other large banks is even more dramatic, with exposure of combined capital falling from 162 percent in June 1982 to 91 percent by December 1985. This decline in exposure relative to capital has occurred even though modest amounts of new loans have been made to some developing countries.

The Act also required the Board of Governors to work toward encouraging governments, central banks, and foreign bank regulatory agencies to maintain and, where appropriate, strengthen the capital base of all banking

institutions involved in international lending. This is more difficult to achieve than raising capital standards in the United States with the most complex problem being agreement upon a common worldwide definition of capital. Nevertheless, advances have been made in focusing supervisory attention worldwide on the issue of raising capital adequacy standards. The Basle Committee on Banking Regulations and Supervisory Practices of the Bank for International Settlements has recognized the need to continue to encourage incremental capital increases, to promote the use of a risk-based system when measuring capital adequacy, and to ensure full consolidation of all significant entities in assessing capital adequacy.

Large U.S. banks have increased capital in part in recognition of the increased risk in international lending. Banks in other countries have raised their loan reserves, which are oftentimes not disclosed, as the preferred method to recognize the increased risk. We believe, however, that most countries have reacted properly by encouraging banks to increase either published capital or to increase loan loss reserves.

In addition to the capital provisions, the Act required the federal bank regulatory agencies to strengthen the supervision of international lending by instituting a series of regulations designed to require banks to establish and maintain special reserves on problem international assets, to force banks to account better for fee income, and to enhance the reporting and disclosure of international lending.

The first main step taken by the bank regulatory authorities to implement these regulations was to initiate a procedure to recognize the reduction in the carrying value of loans to international borrowers in countries that are seriously delinquent and have not taken adequate measures to restore repayment prospects through economic adjustment. Banks whose borrowers are in countries that fall in this category have their loans written down in value through a prescribed formula by use of an "Allocated Transfer Risk Reserve" (ATRR). This process permits an orderly adjustment in carrying value for transfer risk on those countries where economic adjustment has not been followed or has not been successful.

At the same time, the procedures for evaluation and classification of transfer risk within the banking system were also reviewed and, in my view, strengthened. The three regulatory agencies issued a joint statement on examination treatment of international loans shortly after the International Lending Supervision Act was passed. The enhancement announced by the regulatory authorities at that time included new definitions for transfer risk classifications and the identification of a category of international loans called "Other Transfer Risk Problems." These loans represent exposures to countries that have had difficulty meeting fully their external debt service obligations but are taking

positive steps to restore debt service through economic adjustment measures. While not considered in the same magnitude of risk as a classified credit, examiners, nevertheless, consider the total exposure to these countries categorized as "Other Transfer Risk Problems" in assessing asset quality and the adequacy of reserves and capital.

The final regulations concerning accounting for fee income under restructured loans were also issued. These regulations had the desired effect of reducing the opportunity for banks to enhance up-front fee income at the disadvantage of developed countries needing to restructure. These guidelines for recognizing loan fee income were eventually adopted by the accounting profession with only modest changes. In 1983, the fees associated with a restructuring where new money was involved averaged 1-1/4 percent. These same fees now range in the neighborhood of 1/2 percent.

In summary, the International Lending Supervision Act has served as a catalyst in increasing banks' capital and has had the effect of tightening supervisory standards over international lending practices.

DOES THE ACT NEED TO BE AMENDED

The Act itself contains sufficient latitude to issue and amend regulations at the federal banking agencies' discretion. Therefore, the Board would not recommend amendments to the International Lending Supervision Act at this time.

ADDITIONAL PROBLEMS THAT NEED BE ADDRESSED

There has been progress in the debt situation over the last four years. The banking system's relative exposure to developing countries has moderated. Capital and loan loss reserves have been bolstered and the countries themselves have instituted needed changes that are designed to encourage growth and strengthen capital accumulation.

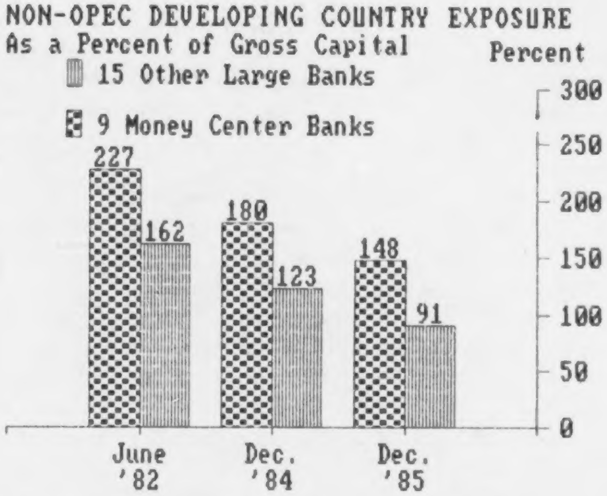
The regulatory agencies will need to continue to work with all interested parties in an effort to arrive at constructive solutions to remaining problems. The regulatory agencies need to continue to encourage thoughtful approaches developed by the banking system, governments and international agencies, and must work with these ideas to fit them in the context of prudential standards of safety and soundness.

Despite the achievements attained to date, however, problems obviously remain. The slide in oil prices has taken its toll, not only on Mexico, but other oil exporting countries as well. On the other hand, lower oil prices will provide relief for most other developing countries. The extent and magnitude of capital flight continues to puzzle observers, with wide disparities between figures quoted. After four years, the world's banking system has still not yet returned to voluntary lending to developing countries.

The conundrums posed would seem to argue for continuing the patient approach of the past. The Baker Initiative provides the framework to sustain the orderly flow

of capital to developing countries undertaking progress in adjusting their economies. The regulatory authorities continue to encourage capital augmentation in the U.S. banking system and continue to raise the issue of harmonizing capital standards among other countries. The U.S. and other banking systems are reserving for countries not making adequate economic adjustments. Progress, while perhaps slow in the minds of some, is being made.

CHART I



Senator HEINZ. Mr. Taylor, thank you very much.

Mr. Bench.

Senator PROXMIRE. Mr. Chairman, before Mr. Bench starts, I'm going to have to leave in about 7 or 8 minutes to go to the floor and I will come back as soon as I possibly can. If this panel is through, I hope you will let them respond to my questions for the record.

Senator HEINZ. Absolutely, Senator Proxmire. Indeed, if you would like to ask Mr. Taylor any questions at this point, I don't think it would be prejudicial.

Senator PROXMIRE. Let me just ask one or two questions. I appreciate that very much, Mr. Chairman.

Mr. Taylor, on October 3, 1985, the New York Times carried an article entitled "Banking Opposition to Debt Plan Seen." It noted that banks have seen their stock values plunge as the extent of their exposure to foreign loan losses has become apparent and they are not anxious to loan more money to troubled nations. The article went on to note that administration officials might use the interest of the banks in changes in domestic banking policies, such as removing some barriers to interstate banking, in order to persuade them to make new loans to debtor nations.

Do you know if the Federal Reserve has made any deals with the banks in conjunction with failing banks in Texas and Oklahoma?

Mr. TAYLOR. I have no such knowledge.

Senator PROXMIRE. May I just ask Mr. Bench and Mr. Collier if either of you have any knowledge of that?

Mr. BENCH. I have no knowledge of that.

Mr. COLLIER. I have no knowledge of that.

Senator PROXMIRE. I have one other question and I am very grateful to the Chair for permitting me to go ahead.

On May 6, Mr. Taylor, the Wall Street Journal carried an article about efforts to securitize and sell investors' interest in the Third World debt now held by various banks. Prof. Richard Herring of the Wharton School at the University of Pennsylvania, is quoted as saying it's a good idea because it would reduce the concentration of loans in the banking system by pulling more creditors into the pool.

What do you think of such a development?

Mr. Taylor. I would prefer to see the process continue to adjust in the manner that it has. At this point, those who are creditors to the developing countries are working together and they seem to have made some progress in increasing their ability to withstand whatever happens, while at the same time not precipitating anything irrational. I would prefer to not see a securitization approach at this time.

Senator Proxmire. Supposing a market—and a pretty big market—develops in LDC debt and the debt is being discounted. How would you justify allowing the commercial banks to value their remaining loans to those same countries at 100 cents to the dollar?

Mr. Taylor. We have had a long history in this country of allowing banks to carry assets at historical cost. As long as the solvency of the borrower is not in question and the borrower can ultimately meet his obligations there does not appear to be any compelling reason to react to short-term price fluctuations. This accounting change was made during the 1930's and I think it significantly helped the banking system from being buffeted by wide temporary, and short-term price fluctuation.

As long as the solvency of the borrower is not in question, it seems to me that it is more logical not to respond to the price movements every day.

Senator Proxmire. Well, how do you react to the fact that European banks in some cases have written down these LDC loans by 50 percent? Do you think they are mistaken in doing so?

Mr. Taylor. It's a matter of how you view what is really being done in an accounting sense. Since 1981 the 10 largest banks have increased their reserves for unidentified but existent problems in their loan portfolios and increased their capital by 50 percent. It is much the same as writing down these assets if you view capital as a reserve. The European banks deal with this issue in a different accounting fashion than the United States and set up specific reserves or alternatively charge hidden reserves but it is functionally the same thing.

In the case of the European banks it is difficult for the public to analyze what is happening as opposed to our system which is more open in an accounting and disclosure sense.

Senator Proxmire. Thank you very much, Mr. Chairman.

Senator Heinz. Very well. Thank you, Senator Proxmire.

Mr. Bench and Mr. Collier.

[The prepared statements of Mr. Bench and Mr. Collier follow:]

STATEMENT OF ROBERT R. BENCH, DEPUTY COMPTROLLER OF THE CURRENCY

Mr. Chairman and members of the Subcommittee, I am pleased to have this opportunity to discuss the International Lending Supervision Act ("ILSA") as well as its impact on international lending practices and the international debt situation.

In my statement this morning, I will begin with a brief review of international lending currently being done by U.S. banks. That will be followed with an update on the implementation of the various components of ILSA. Finally, I would like to discuss the progress that has been made by U.S. banks and debtor countries in strengthening their positions vis-a-vis international debt.

Current International Lending By U.S. Banks

U.S. banks reported holding $312 billion in cross-border, non-local currency claims ("transfer risk") as of December 31, 1985. That amount represents 11% of the total assets in the U.S. banking system as of that date.

These international exposures are concentrated in a relatively small number of U.S. banks.

Nine Money Center Banks	$181 billion	58%
Fifteen Other Large Banks	61	20%
173 Other Banks	70	22%
	$312 billion	100%

Seventy-four percent of the lending is to foreign banks and private sector borrowers, while sixty-six percent is short-term.

Foreign Banks	$147 billion	47%
Private Sector	84	27%
Governments and Agencies	81	26%
	$312 billion	100%

Under One Year	$206 billion	66%
One to Five Years	69	22%
Over Five Years	37	12%
	$312 billion	100%

About $100 billion or one-third of the lending has been made to developing countries.

Developed Countries	$178 billion	57%
OPEC & Developing Countries	120	39%
Banking Centers and Multilateral Institutions	10	3%
Eastern Europe	4	1%
	$312 billion	100%

Progress In Implementing ILSA

On May 30, 1984, the federal banking agencies reported to the Congress on their actions to implement uniformly the provisions and Congressional intent of ILSA. That implementation continues today, as the agencies regularly review and modify their programs in light of experience. We continue to believe that ILSA provides a sound legislative framework for supervising international lending and no amendments or additional legislative authorities are recommended at this time. The major effects of ILSA, and the supervisory policies that implement it, on banks' lending practices are many.

o Under ILSA, U.S. banks have been required to report comprehensively their international exposures quarterly. These reports include data on the banks' largest exposures, which we now disclose under certain circumstances to the public on request. This year, we strengthened the reports by requiring improved data on banks' international risk distribution, trade credits and off-balance sheet activities. As a result of ILSA, more frequent, accurate, and useful information about U.S. banks' international activities is now available to bank management, bank supervisors, the markets, and the general public.

o ILSA imposed new fee accounting and loan documentation requirements. During the past two years, U.S. banks continually have rescheduled many international loans and selectively made new project loans in certain countries. We know of no case where the related fee accounting and loan documentation requirements of ILSA were an impediment to these activities.

o ILSA has provided more useful tools for supervisory evaluation of U.S. banks' foreign country exposures and the integration of those evaluations into supervisors' overall assessment of each bank's condition and capital adequacy.

  oo Since the passage of ILSA, the banking agencies have instituted through the Interagency Country Exposure Review Committee ("ICERC"), a new series of risk categorizations for transfer risks in U.S. banks' portfolios. For transfer risks categorized as "Value Impaired" by ICERC, the agencies have mandated Allocated Transfer Risk Reserves.

  oo Those ICERC categorizations have been: integrated into overall supervisory assessments of U.S. banks; discussed in the agencies' meetings with boards of directors; and, factored into supervisory calls for more reserves and capital at several banks.

o ILSA contains a number of provisions that support supervisory efforts to ensure that U.S. banking institutions maintain adequate levels of capital. Under those provisions, we, together with the Federal Reserve and FDIC, adopted in early 1985 uniform minimum capital requirements for all commercial banks. We also sent to all national banks in 1985 a banking issuance emphasizing the importance of maintaining an adequate allowance for loan and lease losses. The circular pointed out the importance of developing a process for evaluating the uncertainties in international lending that incorporates both credit risk and the potential for transfer risk problems.

- oo **As a result of these initiatives, U.S. banks have considerably increased their capitalization and in so doing reduced their vulnerability to international debt. Since 1982, primary capital has risen $19 billion in 24 of the largest U.S. banks engaged in international lending and over $25 billion in the consolidated holding companies of those banks. Primary capital/asset ratios for these banks improved from 4.9% to 6.6% over the same period. This growth in capitalization includes a $3.7 billion increase in loan loss reserves.**

Senator Heinz. For the record, would you just explain whether the $3.7 million is over and above the $6.6 or is it contained in the $6.6?

Mr. Bench. It's contained within the $6.6.

Senator Heinz. All right. Thank you.

- oo **Overall, this growth in capital, notwithstanding modest additional lending to troubled debtor countries, has significantly lowered U.S. banks' vulnerability to the international debt situation. For instance, since 1983 the nine money center U.S. banks have decreased their Latin American exposure as a percent of capital from 163% to 124%, while the 15 other large banks have decreased their exposure in Latin America from 117% of capital to 71% of capital. Capital exposures to all developing countries decreased since 1983 from 209% to 148% for nine money center banks and from 153% to 104% for the 15 other large banks.**

- o **ILSA also empowered the OCC to issue and to enforce capital directives requiring a bank to increase its capitalization. This authority is a useful supervisory tool and has been used in cases where a bank's level of capital is an immediate and overriding concern.**

- o **Finally, the Federal banking agencies have been making concerted efforts since ILSA to enhance cooperation within the international supervisory community and to make it stronger. We have expanded our participation in multilateral groups to develop a more compatible international supervisory framework for international lending, in areas such as capital measurement, capital adequacy, and off-balance sheet risks. For example, the three agencies are hosting the regular June meeting of the "Cooke Committee" this week in Washington. Bilaterally, we have expanded our contacts and technical assistance to foreign supervisors. This includes working with countries to strengthen their supervisory systems as part of their overall economic adjustment programs. Communication between international groups of supervisors, accountants, and bankers also has been expanded in an effort to better understand accounting and supervisory systems in relation to various financing alternatives being proposed to assist debtor countries.**

ILSA In a Broader Context

In addition to the improved supervisory framework provided by ILSA, debt rescheduling and modest new lending arranged collectively by creditor and debtor governments, multilateral institutions and commercial lenders, have also contributed to strengthening the international financial system. Since 1982, the IMF has lent approximately $34 billion to 72 countries, including $13 billion to Latin America. As part of that collective effort, commercial banks world-wide since 1982 have rescheduled or rolled-over about

$200 billion of developing country debt and have provided roughly $28 billion in new loans to certain LDCs. Overall, these reschedulings and new money packages, linked to economic adjustment by the countries themselves, have enabled many debtor countries to improve their exchange-rate, trade, and liquidity positions, restructure their debt maturities, maintain debt service, and provide a foundation for economic growth.

In addition, policies in the industrial countries succeeded in dramatically lowering interest and inflation rates. A recent movement toward compatibility of policies appears to have led to a better alignment of exchange rates and rates of economic growth. This has provided developing countries with the most favorable external environment since the early 1970's in which to service their debt and proceed with their own policies for sustained growth.

Despite this progress, however, much more needs to be done to address the international debt problem. Some debtor countries need to continue to reduce their high rates of inflation and budget deficits, better align their exchange rates, promote domestic saving, and improve the investment climate to reverse the fundamental problems of capital flight and an over-reliance on external bank lending. A more hospitable climate for foreign equity investment would help attract foreign funds without adding to the debt service problem. However, until certain debtor countries implement credible policies that provide their citizens with confidence to invest their capital in their own country, additional and alternative flows of foreign capital may be difficult to envision.

Commercial bank lenders continually need to balance their policies as well. As discussed earlier, U.S. banks have reduced their aggregate vulnerability to the debt problem. However, it may be in the best interests of the banks to ensure that enough net new bank financing is available to assist debtor countries' meaningful adjustment efforts and thereby continue to support the international banking system. As the OCC stated in 1983, and has observed since, such new lending may help improve the quality of outstanding exposure. Of course, it is ultimately up to the bankers themselves to make these decisions.

The international debt situation has become especially confused by the recent uncertainties in oil prices. Oil importing LDCs directly benefit from lower oil prices. Moreover, lower oil prices have contributed to reductions in interest rates, which will reduce LDC interest payments on their bank debt. At the same time, lower oil prices and lower interest rates should stimulate growth in developed countries and enhance the export prospects of the LDCs.

On the other hand, the plunge in oil prices has focused attention on those debtor countries that are heavily dependent on oil revenues to service their debt. It is too early to determine the net effect of the current uncertainties in oil prices on the foreign debt held by U.S. banks. Even so, it is clear that the fall in oil prices has reduced the ability of some oil exporters to service their debt, and it may mean they will have to undertake additional macroeconomic reforms, perhaps with the assistance of the IMF and the World Bank.

The nature and magnitude of the banks' difficulties in lending to developing countries remain complex. The problems of international debt developed over a long period of time and it will take some time to solve them. Any strategy for international debt, including bank supervision, no matter how well conceived, has to be flexible to adjust to possible changes in the global economic environment. Implementation of ILSA, as well as the collective international debt strategy begun three years ago and recently enhanced through Secretary Baker's Program For Sustained Growth, have led to considerable progress in strengthening U.S. banks' positions vis-a-vis their international loans, while restoring the reserves and liquidity positions of many debtor countries.

STATEMENT OF CHARLES COLLIER, ASSISTANT DIRECTOR, DIVISION OF BANK SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

I would like to begin my remarks by calling attention to Exhibit 1. This is an updated version of the table which appeared in the House report accompanying the International Economic Recovery and Stability Act, which was signed into law on November 30, 1983. Title IX of that Act is the International Lending Supervision Act of 1983 (ILSA). The table provides a useful backdrop to my comments. The data show that country exposure for the nine largest banks, as a percentage of capital funds, has declined from 898 percent of the banks' total capital funds in June 1982 to 428 percent at year-end 1985. This percentage decline reflects the $20 billion increase in the capital of the nine largest banks as well as the absolute decline in total outstanding country exposure, especially to industrialized countries, in these banks. Outstandings to non-OPEC South American countries, however, have increased slightly.

Let ~~me now comment~~ on the agencies' response to the major provisions of ILSA and their impact on international lending practices and the international debt situation.

In December 1983, the Federal Reserve, the Comptroller of the Currency and the FDIC adopted new uniform examination categories for credits that have been adversely affected by transfer risk problems. This was in response to Section 904 of ILSA, which requires the agencies to evaluate banking institutions' foreign country exposures and transfer risk for use in supervision, including evaluation of capital adequacy. New definitions for transfer risk classifications were adopted and a new category, "Other Transfer Risk Problems," was added to highlight transfer risks not warranting classification. Such "OTRP" credits are now considered by examiners as a

judgmental factor in their assessment of a bank's asset quality and the adequacy of reserves and capital. These changes in procedures were designed to be more effective in transmitting agency concerns about transfer risk to bank management. There are presently eleven country exposures which are identified as "OTRP," representing $85.4 billion in total U.S. bank outstandings. Since year-end 1983, exposures to eight "OTRP" designated countries have declined while exposures to three have increased, for a net overall decline of $2.1 billion in outstandings to these countries.

Section 905 of ILSA was designed to address concerns that some banks were not acknowledging errors of judgment in foreign lending by failing to account for potential losses. This section provides for the federal banking agencies to require banking institutions to establish and maintain reserves whenever the quality of the asset has been impaired both by a protracted inability of the foreign borrower, whether public or private, to make payments and where no definite prospects exist for the orderly restoration of debt service. Any reserves established under this section may not be considered as part of capital and surplus or the allowance for loan losses.

In implementing Section 905 of ILSA, the agencies adopted new rules and regulations which became effective in February 1984, providing for a joint determination of assets which are subject to risks warranting establishment of an Allocated Transfer Risk Reserve (ATRR), the size of the ATRR, and whether an existing ATRR can be decreased due to the improved quality of the assets.

Since the inception of ILSA the credits of seven countries have been classified as "Value Impaired." The reserves range from 85 percent, for one country, to 15 percent. To date, the reserves have increased and none have been reduced. At the end of 1983, assets judged to be "Value Impaired" totaled $4.1 billion, including $2.5 billion in the nine largest banks. By year-end 1985, outstandings in "Value Impaired" countries had declined to $2.4 billion, $1.5 billion in the nine largest banks.

In order to eliminate what Congress perceived to be one of the foremost abuses in international lending, the recognition of income immediately upon the granting of a loan rescheduling or restructuring, Section 906 of ILSA directed the promulgation of fee accounting rules. The agencies issued joint regulations in March 1984. The principal provisions distinguish between restructured and all other international loans in establishing accounting treatment for fees. The regulations prohibit the charging of a fee in connection with a restructured international loan unless the excess over administrative costs is deferred and amortized over the effective life of the loan. With respect to syndicated loans, interest yield adjustments must be recognized over the life of the loan, with other fees permissible as immediate income only if identifiable with specific services. Finally, commitment fees must be recognized over the life of the commitment.

In connection with loan fees, we should note that the Financial Accounting Standards Board recently issued an exposure draft on accounting for loan fees, and comments on the draft were due by April 30, 1986. Perhaps ultimate resolution of how to account for such fees would be better left to accounting conventions rather than agency rules and regulations.

In order to provide for more timely data, both to the public and to regulators, Section 907 of ILSA provides that each banking institution with foreign country exposure submit, no fewer than four times a year, information

in a format prescribed by the agencies. The agencies promulgated rules and regulations to implement Section 907 and amended the existing Country Exposure Report forms. In addition, a new requirement for public disclosure of countries and outstandings where the banks' exposures are in excess of one percent of total assets or 20 percent of primary capital was added. Institutions must also disclose the names of those countries where outstandings are between .75 and one percent of total assets or between 15 and twenty percent of primary capital, whichever is less.

Section 908 of ILSA mandates the federal agencies to achieve and maintain adequate capital by establishing minimum levels of capital. It provides that failure on the part of a banking institution to maintain such a level may constitute an unsafe and unsound practice within the meaning of Section 8 of the Federal Deposit Insurance Act. These provisions are aimed at enhancing and maintaining capital levels of U.S. banking institutions whether or not those institutions are involved in substantial international lending.

In April 1985, the agencies finalized rules establishing banks' capital requirements. These rules set, for the first time, uniform capital requirements for all national, federal reserve member, and FDIC insured state non-member banks, regardless of size. Total capital levels were set at 6%, with the requirement that 5-1/2% be in primary capital. Since the passage of ILSA, the average primary capital ratio for the 25 largest institutions has risen from 5.70% at year-end 1983 to 6.97% as of March 31, 1986, ranging from 6.20% to 8.04%; up considerably from a low of 4.73% to a high of 6.49% in 1983.

EXHIBIT 1

Summary of the Country Exposure Lending Survey
Amounts Owed to the Nine Largest Banks
[includes adjustments to reflect guarantees and indirect borrowings]

	June 1982		December 1983		December 1985		
	Amount (in millions)	As a % of Capital	Amount (in millions)	As a % of Capital	Amount (in millions)	As a % of Capital	Percent Change 1982/1985
G-10 Countries and Switzerland	88,264	387.7	82,595	261.9	73,612	173.9	-16.6
Non G-10 Developed Countries	23,770	104.4	25,455	80.7	21,943	51.9	-7.7
Total-Developed Countries	112,034	492.1	108,050	342.6	95,555	225.8	-14.7
Eastern Europe	3,957	17.4	3,269	10.4	2,757	6.5	-30.3
Poland	739	3.2	594	1.9	380	0.9	-48.6
Yugoslavia	1,415	6.1	1,421	4.5	1,406	3.3	-6.6
East Germany	541	2.4	293	0.9	219	0.5	-59.5
OPEC Members	16,209	71.2	17,977	57.0	14,483	34.2	-10.6
Venezuela	7,147	31.4	7,516	23.8	6,946	16.4	-2.8
Indonesia	1,920	8.4	2,659	8.4	1,990	4.7	+3.7
Saudi Arabia	1,706	7.5	1,779	5.6	1,589	3.8	-6.9
Non-OPEC South American Countries	40,660	178.6	42,656	135.3	44,363	104.8	+9.1
Mexico	13,606	59.8	13,738	43.6	13,834	32.7	+1.7
Brazil	12,335	54.2	13,754	43.6	15,837	37.4	+28.3
Argentina	5,595	24.6	5,761	18.3	6,203	14.7	+10.9
Non-OPEC Asian Countries	17,275	75.9	19,972	63.3	15,709	37.1	-9.1
South Korea	5,086	22.3	6,707	21.3	5,174	12.2	+1.7
Philippines	3,677	16.1	3,631	11.5	3,570	8.4	-2.9
Taiwan	2,652	11.6	2,473	7.8	1,184	2.8	-55.4
Non-OPEC African Countries	3,583	15.7	3,226	10.2	2,334	5.5	-34.9
Total Non-OPEC Develop. Countries	61,518	270.2	65,854	208.8	62,406	147.5	+1.4
Total - All Developing Countries	77,727	341.4	83,831	265.8	76,889	181.7	-1.1
Total - All Developing Countries and the Communist Bloc	81,684	358.8	87,100	276.2	79,646	188.2	-2.5
Offshore Banking Centers	9,888	43.4	9,574	30.4	5,457	12.9	-44.8
International Organizations	774	3.4	433	1.4	585	1.4	-24.4
GRAND TOTAL	204,380	897.7	205,157	650.5	181,243	428.3	-11.3
Total Capital of the nine largest Banks	22,767		31,538		42,318		+85.9

In conclusion, the FDIC believes that the Act has had some effect on international lending practices as well as on the international debt situation, but the impact is difficult to measure. Since implementation of the various provisions of ILSA, total outstandings to developing and industrial countries have declined. While some of the decline since 1983 may be attributed to ILSA's increased supervision, reserve, fee accounting, and disclosure requirements, it is likely that other macroeconomic factors have been more directly responsible. Specifically, it is unlikely that reserve requirements have had any significant effect on banks' decisions to lend to "ATRR" designated countries; however, in all probability, the reserve requirements have forced recognition of losses which may have been otherwise deferred. The designation of "OTRP" exposures as an indicator of supervisory concern may have played some role in decisions to lend to certain countries. While total "OTRP" exposures have declined by over $2 billion since 1983, some exposures have increased indicating that the "OTRP" designation has not negatively impacted the decision to lend additional funds to those countries deemed to be taking positive steps to restore orderly debt service through economic adjustment measures.

While ILSA's effect on lending practices is somewhat nebulous, its impact on bank capital positions is more apparent. The average 127 basis point increase in the level of primary capital at the 25 largest institutions probably can be attributed, at least to some degree, to the capital mandate under ILSA. Also, the new disclosure requirements have provided for more complete and timely access to country exposure data.

At this time, the FDIC does not believe that there are additional supervisory problems in the international lending area that need to be addressed by

Senator **Heinz**. Mr. Bench, Mr. Collier, thank you. By the way, I would agree with you that probably the major impact to date of ILSA is in the area of bank capital improvements because of the direction we gave to all of you to do something about that and, in turn, by getting that kind of direction from us, you had the mandate to go out and get banks to do what was necessary—some more than others, I might add—before you even promulgated the regulations.

Second, I think the disclosure requirements—we will be talking about them more, both with you and others—have been a very useful tool for analysts to let the market decide whether banks are overexposed and, in my judgment, your analysis is a good one and I commend you for it. I think it's accurate.

One question which I know the answer to but I just want to make sure everybody else understands who is a little less well-versed on the intricacies of bank accounting, the allocated transfer risk reserves, Mr. Bench, as I know you know, are not included in bad debt reserves, are they?

Mr. **Bench**. That's correct. They aren't included.

RISKS OF INTERNATIONAL LENDING

Senator **Heinz**. Now in 1984 international lending made up about a third of the assets of U.S. international banks, yet nearly 50 percent of the nonperforming assets of those banks were foreign loans. Given the fact that international lending exposes a bank generally to greater risk, shouldn't the capital-to-asset ratios be greater for those banks than for other banks, Mr. Taylor?

Mr. **Taylor**. I would certainly agree with the concept that capital should be related to risk. In fact, the Federal Reserve's proposal on risk-based capital specifically speaks to that issue. Currently, this is what the examination process does. It acknowledges the risks that are specific in a bank and ensures that capital is adequate to relate to these risks. We do follow such a policy, not just with respect to international credit and transfer risks, but also with respect to all other risks including oil, agriculture, and real estate.

Senator **Heinz**. Do you agree that, generally speaking, international lending is riskier than domestic lending? Haven't we had more problems with international lending?

Mr. **Taylor**. I don't know that the evidence is so clear. International lending, broadly gauged, might indeed be shown to be no more risky than domestic lending over time. Right now there are specific situations which could argue the other way.

Senator **Heinz**. Mr. Bench, do you have a comment on that?

Mr. **Bench**. Well, I think the numbers come out that in terms of problem assets and problem loans, energy and agricultural lending domestically add up to about as big a problem as the developing country situation.

Senator **Heinz**. Is there any correlation between capital ratios and either international lending or capital ratios and oil and gas or agricultural lending? If the regulators are doing a good job, you would expect there to be a correlation of having greater capital ratios for those engaged in the riskier area. In fact, a correlation doesn't exist with respect to international loans. Why is that?

Mr. TAYLOR. I would think that the correlation does exist to the extent of the degree of capital growth. In other words, the growth in the capital for those banks most exposed in these areas has been greater, although perhaps in absolute terms maybe not as much yet.

Senator HEINZ. I wish you would give us some information on that because my information is that there's just no correlation.

Mr. TAYLOR. I'm talking about the level of growth, the rate of growth in capital and reserves of the largest banks.

Senator HEINZ. You're saying growth of capital is fastest in those banks with the greatest exposure overseas, but what we're interested in—that's yesterday. Is the growth going to keep up?

Mr. TAYLOR. We would encourage banks to continue to strengthen capital when they have these exposures.

Senator HEINZ. Maybe they had the greater distance to traverse. The rate of growth doesn't prove a darn thing. Maybe they were at hopelessly low capital ratios 2 or 3 years ago. My recollection is some of them were. So greater growth is not something I'm going to get really joyously excited about. So I don't know what that proves. I would like you to supply us with facts, not suppositions about what's going to happen.

Now just answer my question in terms of where we are today. Isn't it true that there's no correlation between overseas risk exposure and international loans and bank capital?

Mr. TAYLOR. Well, I don't know that I could agree with that.

Senator HEINZ. Well, would you go check the numbers and find out and let us know?

Mr. TAYLOR. I will be happy to do that.

[See p. 55.]

Senator HEINZ. Mr. Bench, do you have information on that subject?

Mr. BENCH. It might be helpful certainly when you have pervasive problems in the industry like we have had in terms of international lending, energy lending, and agricultural lending, and you assume that all our major banks are involved in all three sectors, then the amount of their classified assets or criticized assets increase, and with those increases come more expectations from the supervisors in terms of capital.

So you can argue clearly that the dramatic increase in capital in our largest institutions reflects a correlation with an increase in problem assets.

LOAN LOSS RESERVE PROVISIONS

In addition to the increase in capital, we mentioned that there's been an increase in the largest banks of loan loss reserves of $3.7 billion. But what's really impressive, in terms of what some of the banks have done, is what they have provided and then charged off over the last 3 years. For instance, the largest 24 U.S. banks since 1982 have made loan loss reserve provisions of $18 billion. Their holding companies on a consolidated basis have made loan loss provisions of some $24 billion, and, as we say, the loan loss reserves only increased $3.7 billion. So that's an enormous amount of loss recognition that the banks have had.

To come around again to your question, I'd have to say that there's indeed been a correlation between these three problem sectors and the increase in reserves provisions capital in those banks.

Senator **Heinz**. Well, there's no question that the situation with respect to capital and exposure has improved and we are going to get some information from Mr. Taylor to make it clear on the record the extent to whether or not the result of that improvement has been differential with respect to risk, but you raise an important point, Mr. Bench, that the banking community is in a stronger position now than it was 3 years ago.

And let me ask you: Doesn't that argue in fact for a much more aggressive writedown policy of the special reserve provisions by the Comptroller and the creation of more allocated transfer risk reserves? Isn't that called for now, having been awfully conservative on that in the past?

Mr. **Bench**. I think it's a function of a few things. When the three agencies testified before this subcommittee in 1983, we said that we would put in policies for more capital reserves and then, in terms of the allocated transfer risk reserves, we said that for those exposures that were protractively delinquent 6 months or more and not in compliance with IMF programs or the bank advisory committee programs, we would mandate the allocated reserves.

It turns out that since 1982, only seven countries have fallen within that degree of severe delinquency and severe inability to restructure their debts. A number of other countries have been close to that, but then have made the decisions to negotiate successfully with bank advisory committees or agreeing with the IMF on standby programs, and have not gone across that threshold of 6 months or more delinquency and inability to deal with the Fund.

I guess how I would answer your question finally is that I think the three agencies will use the allocated transfer risk reserves and aggressively impose reserves as countries fall within the criteria for the reserves, which is this delinquency of 6 months or more and inability to negotiate a Fund program or a bank advisory committee program.

OTHER TRANSFER RISK PROBLEMS

Senator **Heinz**. Well, let me ask Mr. Collier a followup question. Your testimony indicates that $85 billion of U.S. bank loans are classified in the warning category of "other transfer risk problems."

Now that compares with $90 billion of debt of the 15 major debtors. That seems to imply that almost all of that debt is troubled debt. Yet special reserves, allocated transfer risk reserves, [ATRR's], are applied to only $2.5 billion of the loans.

Why is it that ATRR authority is used so little and isn't more vigorous use of ATRR's justified?

Mr. **Collier**. Well, as Mr. Bench indicated, the ATRR is functionally decided by a committee of senior bank examiners from the three agencies and based on the best information that they have, they arrive at those countries which they believe to be value impaired and therefore set the reserve.

Senator HEINZ. Then what does "other transfer risk problems" mean? I know it doesn't result in a reserving requirement.

Mr. COLLIER. That is correct, Mr. Chairman, but it also is used by examiners as a judgmental factor in determining what the individual level of bank capital and reserves should be and that's a subjective judgment that each examiner makes in examining a given bank.

Senator HEINZ. Why shouldn't you be more aggressive? You've got this huge $85 billion classification which you're not reserving anything against. Surely in those $85 billion where there are other transfer risks there must be some serious ones.

Mr. COLLIER. I think the banks——

Senator HEINZ. Is that the case or not?

Mr. COLLIER. I think the banks have been aggressive in increasing both their reserves and their capital positions.

Senator HEINZ. But that's not what I'm asking.

Mr. COLLIER. In recognition that there is risk in these loans.

Senator HEINZ. I'm asking you, the regulator, about your assessment of risk, not what banks are doing.

Mr. COLLIER. I don't think that those loans have fallen into the protracted category of inability to pay.

Senator HEINZ. I'm not asking that either. I'm asking whether they are risks, a serious risk of any kind—some portion of the $85 billion—are some worse than others and do they have any of the other transfer risk problems? Are they going to create problems?

Mr. COLLIER. There are risks in all categories of loans, Mr. Chairman. Some have more risk than others.

Senator HEINZ. We know that, Mr. Collier. I don't want to seem like I'm hectoring you, but I'm asking you whether there are some serious risks buried in the $85 billion. Maybe Mr. Bench can give me an answer.

Mr. COLLIER. There are potentially some serious risks in the $85 billion.

Senator HEINZ. I would think so.

Mr. Bench, do you have anything to add?

Mr. BENCH. Well, only that in any discussion of loan loss reserves versus a loan portfolio, you're always dealing with latent risks in the loan portfolio. In the case of these 11 countries that Chuck mentions in the OTRP category, the degree of problem those countries have had since 1982 has changed considerably. At one point in time, one country had more trouble than another. Today, another country has more trouble than the other country. The point is that maybe the best way and the most prudential way to deal with something like that is to have an increase in general loan loss reserves against the latent risks in that portfolio should something go completely bad, rather than trying to establish specific reserves against specific countries and essentially mandate losses that need not be taken or would be unjustified.

The other point I'd like to make is that I think all three agencies, in seeking that the banks increase their loan loss reserves and capital over the last 3 years, have certainly factored into their evaluation this large block of assets and the OTRP category as a catalyst to get more reserves in capital. In other words, there may not be some magic formula, but in the agencies dealing with the banks and dealing with the totality of risk in the banks' portfolios, the agencies have emphasized before the directors and bank managements that additional reserves and capital were warranted given this increase in these other transfer risk problems.

Senator HEINZ. Well, I'll have to think about that. Let me ask this one other question before I yield to Senator Proxmire.

It's common practice for Canadian and Japanese banks making new loans to countries whose existing loans are subject to sizable reserve requirements to write down immediately their earnings when they make those kind of loans.

HANDLING NEW LOANS UNDER THE BAKER PLAN

How should new loans under the Baker plan be handled? Should the banks take an immediate charge against their earnings, as is commonly done by banks in other countries, Mr. Taylor?

Mr. TAYLOR. I would say, no. If the loan is restructured and there's a plan put in place that meets IMF standards then new lending should be judged solely on its merits. If it should be classified then indeed it should be, but it shouldn't be classified under a broad automatic policy guideline that requires it.

Senator HEINZ. How can you have one set of loans classified, the old loans, and not have the new ones classified?

Mr. TAYLOR. Whether the old loan is classified or the new loan is classified wouldn't necessarily affect the income stream.

Senator HEINZ. Well, let me be very clear in the question. The practice of other countries is when there are classifications of loans to a country that when there is a new loan—whether it's an IMF agreement or not—and I would always hope there would be an IMF agreement for everybody's benefit if new money was being put into the pot—the classification of the old loan doesn't disappear. It stays on the books. No one knows whether the IMF agreement is going to be carried through. The road to hell is paved with good intentions, so they say. So in comes some new money and that money, it seems to me, is going to be subject to the same classification as the old money.

The question isn't whether it should be classified the same way. The question is whether it should be charged as a writeoff when it's made.

You're saying that new money should be treated differently than old money just because of some promises that are made.

Mr. TAYLOR. No; I'm not saying that. I am saying that to the extent you can make a judgment that the new money has a beneficial impact and improves the ability of the borrower to repay the debt, then I think they have to be treated differently. To the extent that the money does nothing more——

Senator HEINZ. You're arguing for treating the new money differently than the old money or treating the new creditors on a preferred basis versus the old creditors. Is that what you're saying?

Mr. TAYLOR. It depends on your view of what the new money will do. To the extent that new money strengthens the credit then indeed you could have a new view of both the new and the old money.

Senator HEINZ. I'm not arguing about that. That's not the issue. The issue is whether you treat the new money differently than the old money, the new loans differently than the old loans. If the new loans and the program make the debt of the country as a whole more likely to be repaid or serviced, then I don't have any disagreement with what you're saying. But that's not what I'm asking.

Mr. BENCH. First of all, as we testified before the subcommittee in 1983 and subsequently incorporated in some of the regulations of ILSA, we did say that there may be instances where we would not criticize or classify in the same way new facilities versus the old facilities. I think there are gradients around this. You have to look at this thing on a case-by-case basis because you may have certain loans to certain borrowers classified more severely or less severely than other loans because of the difference in the facility.

For instance, a performing trade credit may be a new money package. It may not be classified because it's secured or short term or it has certain features that make it a much more viable asset than the old loans. You could have situations where essentially you have nothing more than a rescheduling of the old loan plus some additional money.

Senator HEINZ. I assume, though, that we are talking about apples and apples, not apples and oranges. I assume we are talking about like kinds of loans that have been made in the past and are classified and that when new loans are being made which affect the exposure of the lending institution, in fact for all intents and purposes they are similar if not identical to the kind of loan we were talking about previously. I understand the difference between financing an export and financing a balance of payments, and those kinds of differences, but I'm trying to find out with old apples and new apples whether we are going to take the same bite out of them.

Mr. BENCH. I think the answer is that we would look at it on a case-by-case basis, but if the new lending supports an adjustment process and it underpins the whole block of lending, then there may be one categorization or classification for all of the lending. It may be a less severe classification because the portfolio has been improved by the joint collective package of an IMF program, a bank advisory committee negotiation, and new money from the banks. There may be split classifications of apples.

Senator HEINZ. How about applesauce?

Mr. BENCH. But I think the agencies have to look at each one of these situations on a case-by-case basis.

Senator HEINZ. I'm going to yield to the core of this group here, Senator Proxmire.

Senator PROXMIRE. On that note of applesauce?

Mr. Bench, Professor Lissakers, who will testify later, says the following in her prepared testimony:

> While banks are better off generally vis-a-vis the debt problem than they were in 1982, the debtor countries are in most regards no better off or even worse off than when the crisis broke. Latin American debtors have paid out more than $130 billion in interest since the crisis began, only to find themselves $50 billion deeper in debt.

My question is this. As I understand the Baker proposal, they tend to treat all nations as if they have a liquidity problem, not a insolvency problem. Aren't any of these LDC nations in insolvency?

And if they are, wouldn't it be wiser to follow a policy of writing down the loans rather than making new loans on the same terms which they are likely to have more trouble meeting?

WRITEOFFS OF LOANS

Mr. **Bench**. Well, my answer would be that if the agencies felt that these were insolvent situations they would mandate writeoffs of the loans.

Under the present criteria of the agencies, as we presented them to the committee in 1983 and then adopted in regulations, our parameters for insolvency are a protracted delinquency of 6 months or more and an inability to make economic adjustment and agree to programs with the IMF or the multilateral institutions and agree to programs with bank advisory committees. The only other thing——

Senator **Proxmire**. Let me just interrupt. My question is, haven't any of them been considered to be insolvent? They are all liquidity problems and only liquidity problems?

Mr. **Bench**. No; some of them have been.

Senator **Proxmire**. Where they have been, can you give me specific instances where the regulators have required the banks to write down the loans?

Mr. **Bench**. Some of these nations are included in our group of value impaired countries and, therefore, we have mandated writeoffs against those loans.

Senator **Proxmire**. And that is how recently determined? Within the last year or two?

Mr. **Bench**. Since 1984, since January 1984.

Senator **Proxmire**. Can you give me roughly an idea of how many have been in that category where the banks have been required to write down the value?

Mr. **Bench**. Well, the seven countries in the value-impaired category.

Senator **Proxmire**. There are seven countries?

Mr. **Bench**. Yes.

Senator **Proxmire**. And roughly how much is involved, in total?

Mr. **Bench**. I believe that the total block of loans in that category must have been about $5 billion and probably almost $3 billion of that has been written off.

Senator **Proxmire**. Almost $3 billion has been written off. OK. Now, Mr. Collier, as you know, the three agencies represented here have been pushing a bill to give themselves powers they feel they need to deal with the banks in Texas, Oklahoma, and elsewhere that may be in danger of failing. The main thrust of these bills would be to overrule existing barriers on interstate banking and allow large money center banks to buy the Texas banks that are in trouble. Mr. George Champion, the former CEO of the Chase Manhattan Bank, testified before this committee on the LDC debt problem 3 years ago. He said that he would look with disfavor on any purchase by a bank with a large portfolio of LDC loans that would further lower its ratio of capital to total assets. I cannot understand why the regulators believe the solution to the banking crisis in Texas is to allow bad energy loans by banks in those

States to be consolidated on the books of the money center banks when the latter are not realistically dealing with the questionable loans already on their books.

Can you comment on Mr. Champion's recommendation on this issue?

Mr. **Collier**. With respect to large problem banks in the Southwest, I think there are only a relatively small number of banks that might have the capitalization and capacity, managerial and otherwise, to acquire some banks in that category.

Unfortunately, or fortunately, as the case may be, many of those banks happen to be in New York and therefore I think that's one of the places that the regulators will obviously look should the emergency provisions of the regulators' bill be passed. That is not to say that there are not banks elsewhere, such as in California, that would have the capacity and capitalization to take over a large failing bank.

Senator **Proxmire**. It seems to me that former executive officers of banks get a lot more wisdom after they retire than when they have a specific interest to defend. I have great respect for Mr. Champion, formerly of the Chase Bank, as I think many people have, and he said that he would look with disfavor on any purchase by a bank with large portfolios of LDC loans—and that's often banks in New York—that would further lower its ratio of capital to total assets.

Now it would seem to me if these New York banks purchase these Texas and Oklahoma banks that are in deep trouble that that would certainly lower the ratio of capital to total assets of the New York banks. After all the Texas and Oklahoma banks, if they are in deep enough trouble to warrant their having been taken over by an out-of-State bank, must have a bad capital to assets ratio.

Mr. **Collier**. That's not necessarily true because the transaction might occur with FDIC assistance and therefore there would be no diminution of the capital of the acquiring bank.

Senator **Proxmire**. Not necessarily, but often that is the case, is it not? It seems logical to me that when you have a takeover of a bank that's in deep trouble—sufficiently deep trouble to warrant breaching the laws of the State and going in and saying that we're going to ignore the laws of the State to prevent out-of-State branching—we're going to permit a New York bank to come in anyway—it seems to me that under those circumstances that the bank would have to be in pretty deep trouble. Isn't that right?

Mr. **Collier**. That's correct.

Senator **Proxmire**. Therefore, you would have a situation that would violate the Champion principle here. In other words, you would have a bank that's already got an LDC debt and they are taking over a bank in Oklahoma that's in deep trouble and therefore weakening their position further, I suppose on the assumption that, as most Chairmen of the Federal Reserve have said, "We can't allow a big bank to fail," so they will be bailed out by the taxpayers.

Senator **Heinz**. Maybe that's why the Fed decided not to show a high profile here today.

Senator PROXMIRE. Well, I think Mr. Taylor is a good, solid profile.

Senator HEINZ. I was thinking about Mr. Volcker actually.

Senator PROXMIRE. Well, he's not that high.

Senator HEINZ. He has a very high profile but, no offense to Mr. Taylor, but Mr. Taylor is shorter.

Senator PROXMIRE. Nobody is as tall as Paul Volcker, unless they're basketball players maybe.

Mr. Collier, when Secretary of Commerce Baldrige testified before this committee on May 14, he said that if a commercial bank has a problem loan and would like to write it off at 10 percent a year for 10 years, it would not be allowed to do so by the bank regulators. He said once a bank admits a loan is not good it has to write off 100 percent of it at once or else immediately set up a debt reserve equal to the size of the loan.

In the first place, is that accurate?

Mr. COLLIER. I think generally speaking, it is accurate. When a bank recognizes that it has a loss, accounting conventions would require that the bank write it off immediately, not over a long period of time.

Senator PROXMIRE. What do you think of Secretary Baldrige's proposal and what are the pros and cons for that kind of a proposal for bank safety and soundness in your view?

Mr. COLLIER. Generally speaking, I would prefer that a bank, once it has a recognized loss, write it off immediately. I think from the disclosure point of view and the public's perception of the bank we are much better off that way than if we allow poor loans to remain on the bank's books.

Senator PROXMIRE. Well, are there ways for our banks to write off these LDC loans over a period of years, in your view, that would be under some circumstances better? Obviously, if you have a big bank and the particular loan you're talking about is relatively modest in relationship to the bank's capital, it might not be such a problem. But would there be circumstances in which you might permit a bank to write it off over a period of years as Secretary Baldrige proposed?

Mr. COLLIER. There may well be circumstances. I'm not aware of any at the present time, however.

Senator PROXMIRE. Mr. Taylor, we will hear from two bankers later, Mr. Haswell and Mr. Hammel, who have both commented on section 908 of the International Lending Supervision Act of 1983 which directed the bank regulators to raise the capital levels of American banks. They both agree that was a good idea, but claim it handicaps our banks in relation to their foreign competitors.

Mr. Hammel notes: "Many of our foreign colleagues still are woefully undercapitalized and their central banks may not have the depth to support even a single large banking failure."

If these criticisms are valid, I don't think the solution is to stop building the capital levels of our banks, but to persuade foreign bank regulators to act responsibly on this issue.

FOREIGN BANKS PERMIT UNDERCAPITALIZATION

Would you tell me if you agree that many foreign banks permit their banks to be undercapitalized?

Mr. TAYLOR. There are countries around the world where banks are undercapitalized. However, if they wish to participate in the U.S. market we try to make sure that there either is a program to build that capital over time or failing that they are excluded from the marketplace.

Senator PROXMIRE. Are you optimistic that our international efforts will help remedy that situation?

Mr. TAYLOR. I think they will help but I think it's something that's going to happen over time. We may not see it in the next few months, but we are working toward that direction. We ourselves are making a step forward by embracing a risk-based capital concept which we now have under consideration.

Senator PROXMIRE. Thank you.

Thank you, Mr. Chairman.

Senator HEINZ. Very well. I have one or two brief questions for our regulators.

LOANS BEING SOLD AT DISCOUNT RATES

According to—mind you, this is almost 1 year old what I'm going to quote from—July 17, 1985, New York Times. There are numerous developing country transactions where loans are being sold at a discount. Loans to Bolivia sell for about—and I quote the New York Times—sell for about 20 cents on the dollar; Peru, under the burden of economic woes, sell for half of its face value; Argentina trades for 70 cents on the dollar, while loans to Venezuela sell for about 90 cents of face value.

While these discount market operations are taking place, banks are still lending money at 100 percent of face value.

Now does it make sense for banks to make loans to those countries where existing debt is being traded at a fraction of face value without recognizing that in some way?

Mr. Collier, do you have an opinion on that?

Mr. COLLIER. I think perhaps part of the function of that trading at a discount rate may be a reflection of the interest rate on the loan rather than necessarily a quality consideration.

Senator HEINZ. Twenty cents on the dollar?

Mr. COLLIER. In some measure. I'm not saying that in all cases and for all loans.

Senator HEINZ. Interest rates have come down.

Mr. COLLIER. I think Mr. Taylor also made the point earlier that——

Senator HEINZ. May I just say, Mr. Collier, there's not a shred of evidence to back up your first comment. Interest rates now versus 1985 on a worldwide basis are lower, not higher, and most of that is a relatively short maturity—5 years or less—at least two-thirds to three-quarters of it. Now 5 years ago it was 1980 when interest rates in this country were 20 percent. I hate to think of what they were elsewhere.

Do you want to try again or should I try someone else?

Mr. Bench.

Mr. **Bench**. Well, Chuck is right, but there is more to the story. We have been following these sorts of articles for about a year. I guess I would start out by saying, first of all, there is this trading, this isolated trading of country debts in what is called a secondary market, but it's a very imperfect market. There are a few brokers or banks acting as brokers dealing in isolated transactions. The nature of the transactions vary by interest rate in terms that a lot of these loans are done at a floating rate spread over the cost of funds and there is a wide variety of maturities of the loans and there's a wide variety in the underlying legal documentation behind the loans. So you don't have any homogenous product out there and you don't have it in volume.

Senator **Heinz**. How much of it do you think is taking place?

Mr. **Bench**. Out of a total stock of about $300 billion of developing countries' external bank debt, no matter who you talk to, they speak of $3 to $5 billion.

Senator **Heinz**. It was $3 billion 1 year ago. Do you think it's more or less now?

Mr. **Bench**. I think it's about the same and it may be the same loans.

SWAPPING DEBT FOR EQUITY

Senator **Heinz**. It could be. Let me ask you this. There are a number of new or innovative approaches being advocated toward international lending. Some people are advocating swapping debt for equity. Others are saying what you want to do is somehow convert that debt into another kind of long-term security. Another development is making interest payments in local currency with possible later conversion to foreign exchange.

Are you concerned about any of those developments? How should they be handled by you regulators and by the accountants, and are banks scared away from these innovations by regulatory treatment? Are they good or bad?

Mr. **Bench**. I think the answer is that probably the development of viable financing alternatives for developing countries would be a good thing. Some of those alternatives are already being practiced on an isolated basis, generally by non-U.S. banks with the countries.

The history of U.S. bank regulation and accounting convention differs considerably from those of other countries. Our Office is discussing with the Federal Reserve, on a continual basis, these sorts of transactions, and are thinking how they could or might or do not fit within the U.S. regulatory scheme or the U.S. accounting scheme.

Senator **Heinz**. Any other comments from any of you on this particular question?

[No response.]

Senator **Heinz**. Senator Proxmire.

Senator **Proxmire**. I just have one more question.

Mr. Bench, of the 15 countries on the Baker plan, is it not true that all 15 have increased their debt over the last 3 years and don't they use new bank loans to pay the interest on their debt so that they will not have to acknowledge that these are troubled loans, and isn't that a con game in which our regulators are playing a part?

I want to know whether they are paying back any principal or simply paying interest.

Mr. BENCH. I'm not certain that all of the Baker initiative countries' external bank debt has increased.

Senator PROXMIRE. But overall it has increased?

Mr. BENCH. I would say as a group of countries it probably has increased modestly over the last 3 years and I would say probably very modestly.

Senator PROXMIRE. For the record, would you tell us how much it has increased? Not now, but tell us exactly how much of an increase that was, for the record?

Mr. BENCH. Yes, we will do that. In terms of—I guess really the question is are the banks paying themselves interest by lending these countries money which comes back?

Senator PROXMIRE. They simply pay interest on it and the debt increases and we're not really making any progress in retiring the debt.

Mr. BENCH. I think the answer there is you get to the classic fungibility question. A number of these countries over the last 3 years have entered into parallel agreements with the International Monetary Fund and the community of banks. Those agreements call for parallel lending from the Fund and the banks to the country to provide the country cash to carry the country through the adjustment program they agreed to in the IMF as well as to build up reserves and pay interest back to the banks. But I would say that it's not a one-for-one relationship. The lending of the banks and the lending of the Fund stir other economic activity in the country, increase exports, build up foreign exchange reserves. From that total pool of funds banks get back their interest, no question about it, but I don't think it's a one-for-one relationship.

Mr. TAYLOR. Senator, I have the numbers as it relates to the increase in the Baker plan countries over the last 3 years. In 1983 it increased by $3.5 billion. In 1984 it increased by $1.2 billion. In 1985, it decreased by $5.1 billion.

Senator PROXMIRE. So the net effect over the last 3 years is——

Mr. TAYLOR. A little bit down.

Senator PROXMIRE [continuing]. A slight decrease.

Mr. Bench, are you any relation to the great catcher on the Cincinnati Reds?

Mr. BENCH. No, sir.

Senator PROXMIRE. You're not. Too bad. You look like an athlete. Of course, so did he.

Mr. BENCH. Thank you.

Senator HEINZ. Gentlemen, thank you very much.

Would our next panel please come forward: Mr. Haswell, Mr. Hammel, and Ms. Lissakers.

Mr. Haswell, please proceed.

[The prepared statement of Mr. Haswell follows:]

STATEMENT OF CARLETON R. HASWELL, SENIOR VICE PRESIDENT, CHEMICAL BANK

I am pleased to accept your invitation to address the Committee about our thoughts on the International Lending Supervision Act of 1983 (the Act) and its impact on the LDC debt situation.

Before making specific comments about the Act, a few general observations might add light to the later remarks. Many factors go into any decision-making process. Regarding the LDC debt situation since the Act was passed in 1983, many conditions in the world have had an effect on bankers' attitudes concerning the extension of credit to LDCs. Some of these factors would include the vastly improved current accounts, the rapid fall in commodity prices, a better understanding of the LDC debt implications by the press and market analysts, the rapid recent fall in petroleum prices, the fluctuating values of the major currencies, the decline in interest rates, the political situations in many of the LDCs and an overall decrease in the developed countries' inflation rates. All of the above factors plus the International Lending Supervision Act of 1983 had an effect on the way banks managed their LDC portfolio. Consequently, it is impossible to say how each of the above independently affected attitudes.

Keeping the above factors in mind, I would now like to make comments on the major sections of the Act.

RESERVES

Following passage of the Act, the Regulators have significantly increased their requests for information concerning the LDCs. This information is used by the Regulators in establishing country classifications. To give an example, three times a year the Examiners meet with various people on our staff to discuss specific countries. Approximately two weeks prior to the visit, they submit a questionnaire which must be completed by the Bank prior to the meetings. We find that a great deal of work is required in completing the questionnaires and conducting the meetings. For example, we have calculated that this process alone cost Chemical Bank $368,000 during the past 12 months. We consider this to be a significant expense.

As required in Section 905 of the Act, the Regulators have implemented specific reserves (Allocated Transfer Risk Reserves) against assets whose value has been found by the agencies to have been significantly impaired by protracted transfer risk problems. Part of the decision on the size of reserves or the decision to classify a country is based on the information obtained from banks during the country reviews. A particular problem we have with the process is that the Bank is not informed ahead of time about the recommended level of the ATRR or proposed classification or the logic as to how these recommendations were reached. In all other loan classifications, the Bank directly or, in cases of Shared National Credits, the Agent is given an opportunity to discuss suggested classifications directly with the Examiners to make sure that the Bank's view is understood before the final classification is given. While to date the ATRR and classifications have, in most cases, been reasonably handled, the banks should be involved more directly in the final process.

One other aspect of the reserves and classifications is that, in some cases, banks have been reluctant to provide even a relatively small amount of necessary funds to countries out of the fear that new loans will be classified and/or new reserves will have to be established. Additionally, new trade credits should not be subject to the ATRR as trade is vital to the recovery process and the growth in world trade. It is important that regulations do not hinder any cure of the problem or constrain world economic growth.

ACCOUNTING FOR FEES ON INTERNATIONAL LOANS

Section 906 of the Act requires that loan fees should be amortized over the term of the underlying loan. This particular part of the Act has had very little effect on Chemical Bank because we had had in place prior to the Act policies that were very similar to the Federal Regulations. One specific recommendation would be that in future regulations the question of materiality should be included. As it stands now, even very small loan fees that are received must be amortized and for small amounts this can be an expensive accounting procedure. For

your information, apart from direct out of pocket expenses, there have been few sovereign loan renegotiations in the past year that have had any significant front-end fees. This has been a natural result of negotiations between the banks and the borrowers and not to accounting treatment of fees.

COLLECTION AND DISCLOSURE OF CERTAIN INTERNATIONAL LENDING DATA

Section 907 of the Act requires additional disclosure of certain international lending data. Generally, we feel that disclosure is important and is adequate. The Regulators in their examination of the banks spend a considerable amount of time reconciling figures on country exposure that are provided by the banks to make sure they are accurate. Additionally, the Regulators have shortened dissemination time for the publishing of aggregate country exposures. This data is essential to keeping track of what is going on in the marketplace.

CAPITAL ADEQUACY

Section 908 concerns capital adequacy of banks. Various capital adequacy provisions have been proposed by the regulatory agencies and are now being discussed. Chemical Bank has submitted our thoughts on the proposals directly to the Federal Reserve as requested. It should be pointed out that primary capital of the top 9 U.S. reporting banks increased by $11.9 billion between December 31, 1983 and December 31, 1985 primarily from the issuance of new securities and the retention of earnings. While capital is important it should be emphasized that

American banks must compete with banks around the world. Some of these banks have no or low capital requirements. It is essential that the U.S. banking system is competitive in the world marketplace in order to finance U.S. exports and U.S. industry in general.

FOREIGN LOAN EVALUATIONS

Section 909 of the Act requires specific foreign loan valuations to be made of large credits extended to finance project loans for various types of mineral or metal operations outside of the United States. Given the poor economic situation in most of the LDCs and low world commodity prices, the demand for new project loans has come to a standstill. Consequently, it is hard to make any comments about this Section of the Act.

GAO AUDIT AUTHORITY

Section 911 of the Act requests GAO to audit various aspects of the Act. Members from the GAO have visited with our Bank.

In conclusion, the past years have been a difficult period for many of the LDCs. Generally a great deal of progress has been made in both the debt restructuring process and the general economic situation. However, a great deal still has to be done to restore creditworthiness in the LDCs. Our Bank supports the Baker initiative and realizes that more time and patience will be needed before full credit confidence can be restored. It is important that the regulatory environment continue to be consistent with other governmental policy. If all the parties work together, the prospects for reaching a solution will be greater.

Senator **Heinz**. Mr. Haswell, thank you very much.
Mr. Hammel.

STATEMENT OF CHARLES M. HAMMEL, SENIOR VICE PRESIDENT, AMERI TRUST CO. NATIONAL ASSOCIATION

Mr. **Hammel**. Thank you very much for the opportunity to share my views on the International Lending Supervision Act of 1983.

[The prepared statements of Mr. Hammel and Ms. Lissakers follow:]

Mr. Chairman, Members of the Committee:

My name is Charles M. Hammel. I am a Senior Vice President of AmeriTrust Company National Association located in Cleveland, Ohio. I am in charge of the Product Management Division of the Corporate Banking Group. As such, the International Department of the bank reports to me. I am here at the request of the committee staff to share my views on the "International Lending Supervision Act of 1983". In re-reading the Act and thinking over the past few days about its implications and implementation, I would have to say that on balance the Act has been a positive force. One of the major problems in international lending during the late '70s and early '80s was that each bank was operating in a vacuum. We were marketing loans in various countries without full knowledge of how rapidly certain affected nations were becoming indebted. Although we can quarrel with the form of certain Federally required reports, the knowledge of what we and our peers are doing, country by country, is essential.

Coupled with this is a better awareness of all the aspects of transfer risk and not just those associated with term loans. Certainly the whole area of Eurodollar deposits and the tremendous level of debt associated with them adds a magnitude of transfer risk which many of us choose to downplay because of the short term nature of deposits. As well, due to this and other pieces of legislation, many U.S. banks have more adequate reserves to deal with possible loan losses in their international portfolios. Although regional banks may be more conservative in their international lending and in their reserve formation, U.S. banks as a whole have begun to recognize that it is essential to set aside adequate reserves for their international portfolios even though the impact on earnings is immediate.

On balance, it was probably prudent to require banks to amortize restructuring fees over the effective life of each restructured international credit. Given the nature of many of the loans, it would not have been as prudent to take the fees immediately into income when much of the principal was in jeopardy and may yet require additional reserve formation or write-off. The area of capital adequacy has received great attention since 1983 through the Act which we are reviewing today and others which recognize that capital formation was not keeping pace with asset and liability growth.

One area, however, where the Act has been less successful is in our Regulator's ability to convince their counterparts in foreign countries to "work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending". Many of our foreign colleagues still are woefully uncapitalized and their central banks may not have the depth to support even a single large banking failure. In addition, the "playing field" is uneven. If U.S. banks are encouraged to strengthen their capital bases and forego dividends to do so, it seems only fair that large foreign multinational banks, generally not as well capitalized as U.S. banks are on average, be required do so as well. I would encourage our regulators to pursue their efforts with their counterparts in other countries to ensure that this process is carried forward.

In the area of foreign loan evaluations, I think that U.S. banks are taking a much more sanguine view of long term loans for development projects. The numbers would seem to bear this out in that extensions of foreign credit in general and project financing in particular have dropped dramatically since August of 1982. AmeriTrust had not done much of this type of lending because our focus was much more export and customer oriented. For those who did participate in infrastructure development projects, I think there is a more realistic view that project finance must be paid for through the project itself and not the foreign exchange reserves of the central bank or the general export earnings of the country.

The role of the IMF and its various adjustment programs, as we all know, has been mixed. In many instances, unforeseen factors have made the adjustment programs virtually impossible to reach even from day one. In other instances, countries have agreed to adjustment programs with no hope of or intent to meet them. Nonetheless, it is essential that the U.S. Government continue to support IMF adjustment programs as a neutral guidepost for multinational governmental lenders, commercial banks and the countries themselves. The Baker Initiative, articulated last Fall in Seoul, recognizes this need and the commercial banks appreciate the recognition that all parties must participate in recovery. As we consider the future and the uncertainties which many of the affected countries - and indeed many of the U.S. banks - face, it is essential to keep all interested parties involved in sharing the responsibilities associated with the ultimate recovery of several of the most indebted countries. In so doing, we must recognize that the individual contributions made by the interested parties may differ for a variety of reasons. For example, many banks might prefer to drastically lower interest rates rather than contribute new loan funds. Other banks whose earnings would be severely impacted by drastically reduced interest rates may prefer to extend further credit. Similarly, various governments may choose to contribute in different ways. If a country prefers to up its contribution to the multilateral agencies rather than to extend direct credit or direct financial assistance through loans or grants, these differences must be recognized. As well, the multinational lending agencies must be willing to provide short term credit in addition to developmental capital. In many instances, developmental projects may not be the first priority but working capital may be essential to a country's survival.

The commercial banks in the U.S. have generally acted in a responsive, constructive fashion since August of 1983. They will continue to do so, in my opinion, with the help of government, multilateral agencies and the countries facing serious problems.

Thank you.

STATEMENT OF KARIN LISSAKERS, ADJUNCT PROFESSOR OF INTERNATIONAL AFFAIRS, COLUMBIA UNIVERSITY

I thank you for this opportunity to testify on the International Lending Supervision Act of 1983 and the debt problem. I have a long-standing interest in the subject of international debt and sovereign risk lending by commercial banks going back to the first oil price shock of 1973-74. I was involved in the formulation of U.S. policy during my years in the government and I have written extensively on the debt issue and banking regulation since leaving the government in 1980. I am now teaching commercial international banking at Columbia University's School of International and Public Affairs and completing a book about country risk lending and the future of international banking that will be published by Random House next year.

Congress and this committee unquestionably strengthened the hand of the regulators and strengthened the banking system as a whole in the debt crisis when it enacted the International Lending Supervision Act of 1983 in conjunction with voting increased resources for the IMF.

Congress took the quite reasonable position that if public funds were to be committed to help these countries and their banks get out of the mess they had got themselves in, then Congress wanted to tighten up the rules that had permitted the lending and borrowing excesses to happen in the first place.

Public debate and the provisions of the law itself put an end to the destructive and short-sighted practice by the banks of widening spreads and puffing up the fees charged in debt restructurings and new emergency financing to boost quarterly bank earnings in 1982 and 1983. More importantly, Congressional pressure stiffened the backbone of the regulators in dealing with the big money center banks, who seemed to be calling the tune, sometimes over the protests of the smaller regional and local banks who wanted to reduce their exposures, not lend more money. Consequently, the banks became more willing to negotiate debt agreements that gave at least some consideration to the cash flow problems of countries like Mexico and Brazil.

I do not want to minimize the dangers to the banking system posed by the debt crisis in that early period or the critical leadership role played by the regulatory agencies and particularly the Federal Reserve and its Chairman Paul Volcker in holding things together. Nevertheless, I think that from the start, not enough has been asked of the banks and a real solution to the problem is therefore more distant than it might be.

In any event, as a result of the 1983 Act, the big banks were belatedly pressed to beef up their capital and for the first time given a specific minimum by the regulators. They were also told to build up general loan loss reserves. Consequently, the banking system in general and the big banks in particular are in a far stronger position to withstand loan losses in 1986 than they were in 1982 (although it is important to bear in mind that there is a degree of double-counting here since our regulators in violation of generally accepted accounting procedures permit banks to treat loan loss reserves as part of capital for capital adequacy purposes.)

Investors and depositors -- as well as law makers -- have clearly benefited from the greatly enhanced disclosure requirements on banks country risk exposures. Banker's may complain that more disclosure limits their room for manuever on the debt question. But there is no doubt that the availability of more information makes possible both a more informed and sensible public policy debate and sounder individual investment decisions. I also believe that greater disclosure has had a salutory effect on the boards of directors of the banks which in the past clearly did not pay as close attention to what their institutions were doing abroad as they should have and which now are held more directly accountable.

Finally, the regulators were given a new tool specifically for overseas loan problems in the Automatic

Transfer Risk Reserve mechanism under which banks can be asked to set aside a special reserve for specific countries (which may not be counted as capital) and write down the loans to such countries by the amount of the reserve. Unfortunately, its use has been limited to a handful of cases, most of them involving very small sums, e.g. Bolivia and Sudan.

The reason is obvious. There is an inherent contradiction in a policy that on the one hand says to a bank, loans to country X are value impaired -- i.e., the prospect of repayment in full is in doubt -- and you must write it down, but on the other says, please lend this country some more money. Because the essence of the "solution" to the debt problem adopted jointly by the banks, the IMF and its member govenments, and the bank regulators since 1982 has been to lend troubled debtors enough money to keep them paying interest to the banks while principal is postponed ad infinitum, regulators have been reluctant to invoke the ATRR for fear of discouraging the banks from participating in the forced lending exercises. Thus banks have been allowed to carry most of their foreign loans at full face value and maintain the fiction that a loan to Mexico when the price of oil is $14 per barrel is as good as a loan when oil stood at $32 per barrel.

But this so-called "solution" hasn't solved the debt problem. At best, it has bought time for the banks to reduce their exposures relative to capital, and in some instances even absolutely. (I note that Citibank -- whose Mr. William Rhodes chairs the bank advisory committee charged with putting together new rescue packages for troubled debtors --has managed to reduce its Mexican loans by $600 million since 1982.)

But as a recent report by the staff of the Joint Economic Committee states so clearly, this time for the banks has been bought at the expense of the debtor countries, and a considerable segment of the U.S export sector.

While banks are better off generally vis a vis the debt problem than they were in 1982, the debtor countries are in most regards no better off or even worse off than when the crisis broke. Latin American debtors have paid out more than $130 billion in interest since the crisis began, only to find themselves $50 billion deeper in debt.

It is easy to think of debts and credits and interest as just so many pieces of paper or electronic blips on a computer screen. But they represent real claims on real goods and services -- goods and services that the debtor must forego for its own uses and make available for others in order to meet its debt obligations in the absence of an adequate inflow of new capital. The maintenance of debt servicing by most debtors since 1982 has come at considerable sacrifice -- drastic import reductions, declining per capita GNP, higher unemployment, malnutrition and infant mortality, the gutting of social spending

programs by governments across the board. The recent drop in interest rates and the weaker dollar have eased the cash flow situation significantly for most debtors -- although in the case of Mexico, not enough to offset the drop in oil prices. But despite the sparkling growth performance of Brazil in the last couple of years and some economic pick-up in Colombia and maybe Chile, Morgan Guaranty's World Financial Markets projects only 1% real GNP growth for the region as a whole in 1986, leaving per capita GNP 8% lower than in 1980. (World Financial Markets, April/May 1986).

Consider what the Bank for International Settlements says about Latin America in its most recent annual report (BIS Annual Report, 9 June, 1986):

> . "Their exports of goods and services, which in dollar terms had grown by 14 per cent in 1984, showed hardly any further increase last year. At the same time, their access to foreign capital narrowed further. Their response was to hold down their imports and terminate or reverse their earlier reserve build-up. Although, in current dollar terms, the growth of their external debt slowed down from $17 billion in 1984 to $12 billion, the weak export preformance meant that, after a substantial decline in 1984, the debt/export ratio rose once more to over 350 per cent. In addition, the ratio of interest service to exports showed hardly any

> further improvement despite the lower level of interest rates. At the same time investment and economic growth, affected by the need for budgetary tightness and foreign exchange economies, continued to stagnate in most countries in the region, while unemployment went on increasing and per capita income showed no improvement or declined even further.

This year it is Mexico and Egypt in crisis because of the drop in oil prices; next year if interest rates rise or the industrial economies go into a slump, it will be Argentina and Chile; the year after, Brazil because there is a glut of orange juice on the market. All the debtor countries remain extremely vulnerable to adverse changes in the external economic enviroment. And we cannot base our debt policy on the assumption that the sun will always shine.

That brings us to the conundrum: these countries cannot grow out of their debts without an inflow of new money, and that new money is not forthcoming because these countries already have too much debt.

The Baker Initiative is supposed provide the capital to enable these countries to grow -- provided they adopt appropriat domestic reforms. But the Baker Initiative is nothing more than the same old policy in a new wrapping, more borrowing from Peter and Paul to pay Paul -- Peter in this case being the IMF, World Bank and IDB, Paul being the commercial banks. As the Joint Economic Committee Study points out, "Comparing these current account deficits to the amount of new loans envisioned by the Baker Plan leads to the inescapable conclusion that the vast majority of new funds will be used to pay interest, rather than to stimulate growth, imports, and development." ("The Impact of the Latin American Debt Crisis on the U.S. Economy", A staff study for the Joint Economic Committee of the U.S. Congress, May 11, 1986.) Chairman Volcker's statement upon his return from hastily arranged trip to Mexico to convince that country's leaders that it is still in their interest to play the game merely reinforces this impression. He told the House Government Operations Committee that Mexico would need an infusion of capital so that it can "maintain interest payments" while it "makes those severe internal adjustments that are necessary."

The Baker Initiative is the right plan, but at the wrong time. It isn't likely to do what it is supposed to do, i.e stimulate a substantial inflow of new capital and rapid economic recovery in the debtor countries, unless some of the old debt is eliminated first.

There is considerable resistance in the financial community to coughing up even the modest amounts of money contemplated by the Baker plan. First of all, tighter regulation of international lending, including the 1983 Lending Supervision Act, and the continuing problems of the debtors, mean that banks view cross-border lending to ldc's not as an area for future growth but a problem of cost containment.

Second, we are dealing with a very different financial market now than in the 1970's: Japan has replaced OPEC as the world's largest capital exporter, and the U.S. is the world's largest capital importer. Commercial banks are increasingly turning their their atttention to markets in the industrial countries where deregulation is opening new opportunities, and they are increasingly making their profits not by lending, but by packaging assets and selling them off to other investors. Financial supluses now flow less through traditional channels of commercial bank deposits and loans than through the securities market, and so far, that end of the market has shown limited interest in the developing countries.

In the absence of a change in policy in Washington and the other important creditor capitals, the big banks will do the bare mininum necessary to keep these debtor countries above water and paying interest, and nothing more. Smaller banks will probably try to back out of the whole business as gracefully as possible.

The outstanding debt is also an obstacle to additional lending by official institutions. Despite the acute need for capital in these countries and plentiful mdb resources, lending by both the IDB and the World Bank was lower in 1985 than the year before. New loan commitments by the IDB were $500 million less in 1985 than in 1984 and almost a billion dollars below the projected target. Actual loan disbursements fell even more. The IBRD maintained new loan commitments, but disbursements were lower in 1985 than in 1984.

The problem does not lie with the development banks but in the recipient countries which lack the budgetary resources to provide the local counterpart funds required as part of the cost sharing in most mdb projects. And these governments are unwilling to start new projects such as schools, hospitals, and roads that will then require additional government expenditure for operating costs.

The fiscal crisis is part of the larger debt problem. Government revenues are down because economies are depressed while debt servicing costs have risen. The Mexican government estimates that 40% of total government expenditures this year will go for servicing the foreign and domestic debt; an estimated 35-40 per cent the Brazilian government's revenues will be used for debt servicing. Much of the original foreign borrowing was of course done by the governments as was most emergency borrowing in the last three years. But the problems has been compounded by another little-noticed development: the commercial banks have insisted in some debt restructuring negotiations that the governments assume the foreign debt obligations of failing private sector borrowers.

Take the Philippines, for example. The public sector's share of all U.S. bank claims on that country increased from 39% in December 1981 to 61% of the total by September, 1985. Stated another way, while the total Philippine debt to U.S. banks rose only 2% in this period, the public sector's U.S. bank debt increased by 59%. Last spring I asked the head of the Philippine central bank, Jose Fernandez, Jr., about this phenomenon. He admitted that it was part of the deal with foreign banks that they be given the option of converting commercial debt, including claims on failed Philippine banks, to public sector debt. "That was part of the negotiations I didn't like, but I had no choice," he said. The same deal has been forced on other debtors. Brazil's public sector debt to U.S. banks has doubled, Mexico's has increased by 54% (not counting the foreign debt of the banks nationalized in 1982), and Chile's by 140%, since 1982.

This increased concentration of foreign indebtedness in the public sector is in my view one of the most distressing features of the debt crisis approach of the last three years. Rather than seeing a natural, gradual and manageable decomposition of some significant portion of the outstanding debt as private sector borrowers became insolvent and the banks wrote off their loans, we have instead had a concentration of the debt into one large, indigestible lump. Just imagine what the U.S. government's debt and budget outlook would be if each time a domestic oil rig supplier or farm equipment manufacturer went bust, Washington had to take over its debts!

There is a lesson in the experience of the 1930's, when many Latin American countries also went through a debt crisis. Some countries managed to grow by declaring a moratorium on interest and principal and turning their economic policies inward. Commercial creditors were eventually compelled to grant bigger and bigger concessions on debt servicing, but held to the principal that the total debts should eventually be paid. Finally, the US and Britain, the two largest creditor nations, trying to restore some order to world economic affairs in the 1940's, seized the initiative. They preempted the commercial creditors and negotiated agreements that involved massive write downs of Latin debt obligations. Only then were these countries able to resume normal participation in the financial markets and enter a period of rapid economic growth and development. Mexico's public foreign debt was written down from $500 million to $50 million in 1942, Brazil's debt was written down to a quarter of its nominal value. (See Angus Maddison, *Two Crises: Latin America and Asia 1929-38 and 1973-83*, OECD, Paris, 1985.)

What is needed now as in the 1930's, is some way to wipe the slate clean, some form of international bankruptcy proceeding -- not for all the debtors, not for every cross-border loan to Latin America or Africa. But the private markets should be given some strong incentive to break down this debt into digestible chunks.

The regulators could get the process started by invoking the ATRR more broadly. Once banks were told that they could not carry a certain loan or category of loans at full nominal value and would have to tie up earnings in loan loss reserves to boot, they would be strongly encouraged to find some way of packaging the asset and selling it off at an appropriate discount. Banks are said to have made only

limited use of swaps and conversions of loans into marketable securities because they fear that they might be forced to mark other loans in that category to market. Regulators can eliminate the uncertainty by saying that this year, loans to the government of country X have to be carried at 80 or 90 per cent of face value, next year at 70 or 60% of nominal value unless there is a dramatic turn-around, and so on. Then the banks can choose whether to hold on to the discounted asset or get it off the books altogether.

Discounting foreign loans in a secondary market doesn't automatically eliminate the debtor's obligation to pay full face value of the original loan. This only happens if the loan is converted into an entirely different animal, say equity in a local company, or a perpetual bond, perhaps bearing a fixed rate of interest, so that principal never has to be repaid. Here government leadership is probably necessary. For example, let the IMF or the World Bank guarantee the interest on a fixed rate perpetual bond which Mexico issues in place of a foreign bank loan and which the creditor bank sells at a discount that offers the purchaser a yield higher than the fixed rate of interest paid by Mexico. Obviously, this process will be costly to the banks, but by no means devastating. It leaves the solution to the debt problem up to the private markets, and lets the markets decide which debtors are worth betting on and at what price. What governments have to do is push the markets in the desired direction.

The first step in this process is to make clear to the banks that Washington or the IMF or the World Bank will not always rush to the rescue and render them whole while the debtor countries sink deeper into the morass.

Sovereign countries can't go bankrupt in the conventional sense. But countries, like corportions or individuals, need some way to escape their past mistakes and make a new beginning.

Senator HEINZ. Mr. Hammel, Ms. Lissakers, thank you very much for that testimony.

Let me ask Mr. Haswell—the Baker initiative states that LDC's themselves have to undertake reforms if their debt problem is going to be resolved. Now you come from a very important money center bank. Your bank sits on a number of country advisory committees which try to assemble new loans to support country reform efforts and you must be aware of the slow progress to get countries to resolve their underlying problems.

How does your bank, Chemical Bank, justify new loans to countries under these conditions?

AMOUNT OF NEW LOANS LIMITED

Mr. HASWELL. I think actually the amount of new loans that you're talking about has been very limited in terms of actual dollar size over the last year or 2 years. In fact, there's been very little new money going into the problem countries. It's key to all of these negotiations that go on. We do not sit around and say "Country X will get 2 percent new money or 3 percent new money." There's a lot of discussion and a thought process as to how the money is going to be used and what is the reason for it. I would say that is where all the time is spent, is trying to determine how that country is going to develop the necessary procedures in order to repay the loan.

It's very difficult for the banks to continue to see the solution to the problem to be just lending more money. I think that creates additional debt. In some cases, new money will be needed, but I think it's going to be parceled out, at least from our view, very slowly, and I think it will be along project-based lines and the continuation of trade. It's essential that the countries have to reform. It's very difficult. We're seeing progress. There's very slow progress in terms of some of the debt to equity swaps and allowing some more foreign ownership of resources in some of the countries. There's a lot of national pride in many of the countries wanting to keep industry within their own control. I think it is this part of the process that will take many years or a long time to change.

Senator **Heinz**. What is your view on the debt-equity swaps and the other innovative arrangements? Do you like them? Do they raise questions for you? Do they raise questions for the regulators?

Mr. **Haswell**. Let me take it piece by piece. I do not think that the debt-equity swap will be the solution to the debt situation. I think it will be a positive contribution. In some countries it might be a substantial part of the solution.

I think that what you're seeing now is some creativity as to how to transfer some of the debt into equity ownership. Obviously, for it to work, there has to be some equity there and assurance that in the long run, whoever holds that equity will be able to get a sufficient return and have the assurance that at some point in time, the profits from that will be able to be repatriated.

I think it's a positive direction and one that will probably grow, but it will not be the end-all solution.

Senator **Heinz**. Mr. Hammel, any comments on that?

Mr. **Hammel**. I agree with what Mr. Haswell has said. It's not the only solution, but it's something that we have to consider. I think in general—and I don't want this word to be taken the wrong way—but I think in general, we have to be more creative than we have been in the past. I agree with Ms. Lissakers that new money per se is not the answer. New creative options to consider along with the regulator, along with multilateral governmental lenders, is the way to go. Debt-equity per se has some appeal. There's a very interesting one in today's Wall Street Journal, but it's not the only solution.

Senator **Heinz**. Any comment on that, Ms. Lissakers?

Ms. **Lissakers**. I think there isn't any one solution. I think, as Mr. Hammel said, what's needed here is a little creativity, and my point is simply that the banks are more likely to be creative if they see that as a lower cost solution than the current solution which is to carry this at full face value and continue to get interest in most instances. There's no incentive as long as you've got the loans and the regulators are saying they are OK and the IMF making the money available for the interest, and there's very little incentive for the banks to go through the complexity and the cost of converting it.

Senator **Heinz**. Let me go back to Mr. Haswell. Has Chemical Bank used any of the approaches of debt-equity, conversion to long-term security and so forth? Have you used any of those at Chemical Bank?

Mr. **Haswell**. We have been looking at some debt-equity swaps. We have not done any yet. We have not accepted also local currency payments in lieu of dollars without some Federal guarantee—Federal guarantee of the borrower—that indeed that was still a dollar claim. In some cases you have seen private sector borrowers come up with local currency payments to the local government and transfer that claim from the local borrower to the Federal Government and I think that's OK because you're still maintaining a dollar payment. But what would be unacceptable would be for a borrower in a foreign country to use local currency to repay a dollar claim. Several things would happen. Say we received pesos or whatever the currency would be. We would then immediately, provided foreign exchange restrictions allowed, convert that peso back into dollars, which of course would drive the currency rate way down. So to make that effective you would have to have foreign exchange controls. Consequently, what you would be saying—most of the countries' inflation levels are still relatively high and as inflation varied versus various countries you would see a large variation of the dollar exchange rate value of those pesos and that would be unacceptable.

Senator **Heinz**. My time has expired. Senator Proxmire.

Senator **Proxmire**. Ms. Lissakers, let me read from an article in the Washington Post yesterday and then I want to get your comment in connection with a question I have here.

This is an article by Hobart Rowen about a speech made yesterday by former West German Chancellor Helmut Schmidt. He said:

> The huge debt owed by Third World countries "will never be paid back," and even the interest on it now being transferred to the richer industrial nations must be sharply reduced. Mr. Schmidt was speaking at the opening session of a 2-day conference here on the future of the World Bank.

My question is this. The regulators told us today that our banks have dramatically raised their capital over the last few years and the LDC debt crisis is not as severe as people like former Chancellor Schmidt say it is.

STOCK VALUE OF MAJOR BANKS

Can you tell us whether the stocks of the major banks are still trading below their book value and, if so, is this an indication from the market about its concerns over bank holdings of LDC debt and is the market evaluation of their stocks a valid indicator of concerns about the real value of these LDC loans?

Ms. **Lissakers**. I think there's been a significant improvement in the stock values of the large commercial banks and a number of the bank stock analysts are quite bullish on the money center banks' prospects, in part because of the improvement in the capital base.

Senator **Proxmire**. Wait a minute. My question was not whether the price is going up. It's whether or not they are still trading below their book value.

Ms. **Lissakers**. It varies. I'm trying to think back. Some of the big money center banks are above and some are below, I believe.

Mr. **Haswell**. I can give it to you.

Senator **Proxmire**. How is Chemical Bank doing?

Mr. **Haswell**. We are just about at book value now, but we have come up from way below book value. Some days we are trading slightly over book value.

I think the group of the banks are just around the book value or slightly over, depending upon where the market happens to be, but it's a vast improvement over 2 years ago.

Mr. **Hammel**. There was a very comprehensive review of the bank stock prices relative to book and other measures in an American Banker article last week. I believe it was last Thursday. Don't hold me on the day of the week. But it went quite comprehensively through all the bank stock prices and where they were to book, et cetera.

Senator PROXMIRE. How about the regional banks? Are they doing better?

Mr. HAMMEL. Much better.

Senator PROXMIRE. And they are not as heavily into LDC loans?

Mr. HAMMEL. That's correct.

Senator PROXMIRE. Do you think the LDC holdings are part of the reason why the stocks of the money center banks aren't doing quite as well?

Mr. HAMMEL. I don't believe so, no.

Senator PROXMIRE. You don't think it is a big factor?

Mr. HAMMEL. No, I do not.

Ms. LISSAKERS. I disagree. I think there was an immediate response, for example, when—the market has become more sanguine about the international debt problem and the bank analysts have in their commentary, but when the Mexican situation heated up again, I think there was immediate response in the stock market and an impact particularly on the money center banks that are known to have the largest exposure.

So I think it is a considerable factor in the market's assessment.

CURRENT DEBT POLICY IS MISTAKEN

Senator PROXMIRE. Robert Lorenz, a former senior vice president of the Security Pacific Bank, who has extensive experience in Latin America, told the Joint Economic Committee yesterday—they had a similar hearing as you may know—that the current administration debt policy is mistaken. He claims our banks, in his judgment, should write off a minimum of 30 percent of the debt over the next 10 years. When Mr. Champion, the former CEO of Chase Manhattan, testified here in 1983, he also recommended banks write off some of these loans.

On November 19, 1984, the American Banker carried an article about a speech made by David H. Levey, then vice president and manager of Country Risk Review of the Wells Fargo Bank in San Francisco. In his speech Mr. Levey said European banks are acknowledging the inevitable truth that a large part of the LDC debt is no good. He charged that the American banks and the American regulatory authorities have colluded both in terms of accounting and in terms of the process as a whole to avoid doing that. Mr. Levey lost his job shortly after making that speech. This may shed light on why retired people are a little more frank and a little more critical of the present treatment of this LDC debt.

That may be why we find former bankers giving us advice that the loans should be written off, while currently employed bankers do not. Can you both comment, both Mr. Haswell and Mr. Hammel, on the pros and cons of having banks begin a process of at least writing off some of these debts to countries such as Mexico who have been hit so hard by falling oil prices?

You're both bankers who are not retired and you're obviously young and vigorous and each have 20 or 30 years ahead of you, provided you answer this question correctly.

Mr. **Haswell**. I think that you're throwing out several large statements and I think they have to be disaggregated.

In some of the countries that are having very severe problems we have written off some of our exposure to them. That is in some cases greater than the ATRR type requirements and I think in those countries it's probably a very clear characteristic.

I can go to the other extreme of an LDC where you take a country like Taiwan, a very defined LDC. They have repaid virtually all of their debt and have reserves. Korea is looking in excellent financial shape right now. They have developed their economy, with few natural resources. That would also fall within that same category. Again, I would dispute it. I think there are all sorts of variants within that and a gross statement would be incorrect.

In terms of all the Latin American LDC's or the ones in restructuring, which I think they were probably referring to but I can't be certain, we do not think that it is a situation where the loans have to be written off. I'm talking about the major countries. It's also not one where you're going to see the solution by throwing in large new amounts of money. But the situation has to be where these countries become creditworthy. This is going to take many different things to happen, but basically it's one where the lenders feel comfortable that their loans will be repaid and at the same time other lenders—if a particular bank wants to get out for whatever reason, another lender will be willing to make that loan. Again, this is, I would guess, a definition of creditworthiness.

We have some cases now in some of the countries that have been restructured where there have been people willing to make new loans. In some cases, the lenders have no exposure or very little.

One of the concerns is what happens if, through the regulatory environment, all of a sudden those loans are classified or have to be reserved against or partly written off. Therefore, the lenders are staying out of it because they are worried about this overhang.

Putting mandatory reserves across the board on all LDC's would be detrimental to the long-term solution.

CONFLICT ON AMOUNT OF LDC DEBT

Senator **Proxmire**. Let me ask you, Ms. Lissakers, you were here when the witness from the Federal Reserve proposed that the aggregate amount of LDC debt has declined in recent years. That seems to be in conflict with the statement on page 5 of your testimony that the Latin nations have paid $130 billion in interest since 1982 but are $50 billion deeper in debt. Who's right?

Ms. **Lissakers**. I don't know what figures they were basing that on. There have been other countries outside of Latin American that have reduced their indebtedness. That's quite true. So maybe on a worldwide basis there's been a decline. The $50 billion figure actually comes from this very recent and I think quite good report by the Joint Economic Committee, and they base their $50 billion figure on a report issued by the State Department issued a few months ago.

Senator **Proxmire**. And you say that's recent?

Ms. **Lissakers**. Yes, but that refers specifically to Latin America.

Senator **Proxmire**. Through May 1986?

Ms. **Lissakers**. Well, the date is probably as of yearend 1985. The Fed data, I think, covered all LDC's and I don't know whether that included OPEC members or not.

Senator **Proxmire**. Mr. Haswell, you say on page 5 of your testimony that your bank supports the Baker initiative and its proposal to have the commercial banks put $20 billion more into the debtor countries over the next 3 years. On November 19, 1985, the Wall Street Journal carried an article on the Baker plan in which it was asked why banks would put more money into the debtor countries. Assistant Secretary of the Treasury, David Mulford, is quoted as saying,

> The biggest banks really don't have much of a choice. They have enormous exposure in the major debtors, exposures so large they can't easily write it off or turn their backs on it.

While that may be true in regard to the money center banks, it is not true with regard to many of our regional and smaller banks. Is there a difference of opinion that has developed between our most exposed and lesser exposed banks on how to deal with LDC debt? Are you aware whether the bank regulators are using any pressure to keep the smaller banks in line on this matter?

Mr. **Haswell**. I can't comment on the pressures that regulators might have on the smaller exposures. What you do see is if a bank has a $3 million exposure total in a given country, it's very easy for that particular bank to say, even though it may be large relative to its size, "We don't want to know anything more about it. It's not worth our time," so they will take a writeoff on it and then they will be done with it. In that case, you do find a big difference. The example above is not typical or widespread and would apply only to a few banks with very small exposures.

We have a fairly large exposure in many of the LDC's and obviously we would not be taking that position and say, "Well, we're just going to throw up our hands and walk away from it."

So it's true that we have to be there throughout the solution and we encourage whatever that solution is going to be. Again, it's a question of relativity, I think.

Senator **Proxmire**. Thank you very much.

My time is up, Mr. Chairman. I have a question for Mr. Hammel which I think he can answer for the record.

Senator **Heinz**. Very well, Senator Proxmire.

Senator Gorton.

Senator **Gorton**. Thank you, Mr. Chairman. I'm here late. I do not have any questions.

Senator **Heinz**. I want to thank all our witnesses. I do have one last question for Ms. Lissakers which I want to submit for the record to you.

I want to thank all of you for your testimony and I thank the committee for their interest in this matter. Are there further questions?

[No response.]

Senator **Heinz**. If not, the hearing is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[Response to written questions follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM WILLIAM TAYLOR

Question 1

At the hearing, we discussed the lack of correlation between levels of bank capital and exposure to troubled LDC debtors, a generally risky category of loans.

Can you demonstrate a positive correlation between bank capitalization and exposure to LDC debt, especially LDC debt rated as troubled ("Other Transfer Risk Problems" or below)? Please provide the data to back up your answer. Is there a correlation between such exposure and changes in capitalization since ILSA's passage in 1983?

Answer

I continue to believe that there is a positive correlation between growth in bank capital and exposure to LDC debt. Since the beginning of the debt crisis in 1982 claims on developing countries, excluding oil-exporters but including Mexico, are virtually unchanged. The nine largest money center banks have actually seen their exposure to this group of countries decline. Meanwhile, the capital of these nine largest money center banks has increased from $29 billion to $42.3 billion during this period. The following table should demonstrate this point.

Nine Largest Money Center Banks

	1982	1983	1984	1985
Exposure to Developing Countries (in Billions)	66.3	65.9	66.2	62.4
Primary Capital (in Billions)	29.0	31.5	36.7	42.3

There does not appear to be any question but that capital is increasing at a significant rate while developing countries exposure is declining.

In terms of countries designated as other transfer risk problems and countries whose outstandings are classified as substandard or value impaired there is even a greater correlation. For purposes of this illustration, all countries whose borrowings were considered as "other transfer risk problems" in 1985 were assumed to be in the same categorization as in 1982 although most were not. The same is true for the classified countries.

All U.S. Banks

	1981	1982	1983	1984	1985
Countries whose outstandings are categorized as "other transfer risk problems"					
As a Percent of:					
Primary Capital	193.7%	185.8%	160.7%	137.5%	116.4%
Total Capital	175.4	172.3	151.6	127.3	88.2
Countries whose outstandings are classified as substandard or value impaired					
As a Percent of:					
Primary Capital	18.0%	16.8%	13.1%	8.9%	6.0%
Total Capital	16.3	15.6	12.3	8.1	4.6

The bank regulatory authorities commenced a program of increasing capital in the largest banks in 1981. Since then, capital has been increasing in the larger bank holding companies at an average rate of roughly 19 percent per year. This average increase did not accelerate after the passage of the International Lending Supervision Act in 1983.

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HEINZ--TAYLOR

Question 2

The $90 billion of LDC debt held by U.S. banks that is rated as troubled (in the OTRP category or below) compares to $105 billion of total capital for those banks. Doesn't this argue for significantly stronger reserve positions and higher capital requirements for banks with heavy exposure to troubled LDC debtors than for other banks?

Answer

In determining the level of capital and reserves that a bank should maintain, the level of criticized assets, including loans categorized as "Other Transfer Risk Problems", are but one factor in the overall determination. Even if two banks have the same high level of exposure to borrowers categorized as "Other Transfer Risk Problems" the degree of risk could be considerably different. If one bank has exposures predominately short term and trade related in nature it would have a lower risk profile than one in which exposures were largely long term loans to private sector borrowers. Therefore I would not necessarily agree that solely because a bank has high exposure to developing countries categorized as "Other Transfer Risk Problems" should it be required to maintain a higher capital level. It would depend on an analysis of the type and maturity of loans being made, to which borrowers and in what countries.

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HEINZ--TAYLOR

Question 3

The Baker Plan calls for the extension of new credit to many of the nations where loans are already unfavorably categorized and which have continued to suffer from severe economic problems despite implementation of policy reforms.

How can a new loan to such a country not be classified when loans existing on the books have been continuously classified? Should not these new loans be carried on the books at less than 100% of face value to reflect the risk that is already recognized in other loans to the same country?

Answer

Most of the countries named in the Baker Initiative are in the "Other Transfer Risk Problem" category. For both this category and for the Substandard category there is no policy for treating new credits differently from existing credits. Loans in these categories generally are fully current as to interest, even though in most cases principal payments have been renegotiated. Designation as OTRP or Substandard does not indicate that there is a loss in the loans but only that these loans have certain problems that increase risk. Neither U.S. regulatory practices nor Generally Accepted Accounting Principles require a write-down of value of such loans, either for domestic or international credits.

Write-downs are required for loans classified "Value Impaired". Such loans are characterized by protracted payment arrearages. However, not all existing loans to a country are necessarily classified Value Impaired. Often, for example, trade credits carry a lesser classification of substandard. This occurs because most countries give priority to servicing trade credits, and these credits are kept current even though other credits are not being serviced. The agencies have stated that they will not automatically require reserves against new credits to countries where some credits are classified value impaired, but will instead first review the countries' performance in servicing such new credits.

An integral feature of the Baker Initiative is that countries needing additional financial support from commercial banks (and the World Bank) are pursuing sound economic policies and are adopting policies of structural adjustment. To the extent these countries are pursuing such policies, the prospect of adequate debt servicing for both "old" loans and "new" loans is enhanced.

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HEINZ--TAYLOR

Question 4

ILSA requires that countries that are delinquent in their debt servicing payments and who have not taken adequate adjustment measures to restore repayment prospects through economic adjustments must write down their loans through an Allocated Transfer Risk Reserve (ATRR). Despite the large volume of LDC debt rated troubled, imposition of special reserves by regulators has been very limited, leaving banks to decide on the appropriate reserves for most LDCs. Only $2.4 billion of loans are covered by ATRRs. Since so much of LDC debt is questionable, and the banks are now in a stronger position to handle write-downs shouldn't the regulators more aggressively pursue the creation of ATRRs.

Answer

For the vast majority of countries debt service is current and the loans do not meet the requirements for imposition of an ATRR under the International Lending Supervision Act and the regulations issued by the bank regulatory agencies. So long as a country continues to service its debt and take adjustment measures it does not seem that an ATRR is warranted. However, banks are encouraged to increase capital and general reserves in recognition of the increased risk of both international and domestic credits in today's environment.

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HEINZ--TAYLOR

Question 5

The Associated Press reported Chairman Volcker's comments to the Overseas Development Council that LDC debt write-downs are a "dead end." Chairman Volcker argued that for the debtor countries, the case for maintaining timely payments is overwhelming and that, with few exceptions, borrowing countries can service outstanding debt. The major debtors have been attempting to maintain normal creditor relations and restore growth for 3-4 years now. Is there evidence to support the case that they are economically better off or closer to fully servicing their debt than if, instead of access to more credit, they had received debt write-downs or interest rate concessions of the same magnitude?

Answer

Only moderate amounts of new credit have been made available to the major countries experiencing debt problems. Both new credit and reschedulings have been provided within the context of comprehensive economic programs that are aimed at both stabilization and structural adjustment. Without the availability of new financing, not just from commercial banks but from the international community more broadly, it seems unrealistic that countries would have been able to institute policies necessary to achieve stabilization and growth. Instead, they would have been induced to adopt policies that forced more disruptive and severe adjustments on their economies. I believe that the major borrowing countries have made progress in restoring internal and external balance. They are certainly in a better position to resume sustainable growth than they were in 1982.

Question 6

From our discussion at the hearing, it is clear that there is a growing recognition that some LDC debt is not worth the full face value. A secondary market is trading the debt of a variety of countries at a discount: some banks are writing down LDC debt; and you the regulators are mandating reserves for selected countries. However, where debt is being written down, little of the benefit of reduced debt service is received by the LDCs.

Why shouldn't regulators be taking a more accommodative stance toward debt settlements arranged between the bank and LDC creditors involving modification of terms on troubled debt securities and/or acceptance of assets in lieu of cash (equity securities, goods, real estate, etc.)? What are the benefits or problems of applying the guidelines of FASB 15 and general regulatory forbearance to the LDC debt problem?

Answer

The terms of debt renegotiation are a matter between a country and its creditors. The lack of debt forgiveness is probably due to the fact that banks, like most lenders, expect to be repaid in full. There is also the question of whether weak borrowers should pay less than those countries that manage their affairs in a way that enables them to service their debt. As far as I know regulatory policies have not been an impediment to the negotiations between banks and countries. If specific problems do arise, I am sure the regulators will review their policies to see whether changes are warranted.

FASB 15 requires banks to state the amount of "Troubled Debt Restructurings", defined as renegotiated loans where interest rates have been reduced due to a deterioration in the condition of the borrowers. FASB 15 currently applies to both foreign and domestic loans. To date, foreign debt restructurings have not met the criteria for reporting under FASB 15. However, large exposures are reported separately so that individual investors can make their own assessment of the impact of these credits on a bank's condition. In my view, where there is this separate disclosure, their is no benefit in mixing a large amount of country risk credits with other credits, which because of commercial risk characteristics, warrant classification as "Troubled Debt Restructurings."

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HEINZ--TAYLOR

Question 7

A number of innovative approaches toward international lending which provide some debt relief to borrower countries are being developed:

- debt-equity swaps
- conversion of debt into long-term securities
- interest payments in local currency, with possible later conversion to foreign exchange

How should these specific approaches be handled by regulators and accountants? Are banks scared away from these innovations by regulatory treatment, or is the current regulatory framework supportive of institutions passing along debt relief to the countries? What are the legal, accounting impediments?

Answer

I believe that the primary factor limiting these or other approaches is the ability of the banks and the countries to arrive at terms that are acceptable and equitable for both sides. For example, with debt-equity swaps, while much has been done in some countries, many other countries are reluctant to open attractive sectors of their economies to significant foreign participation. Likewise, there is nothing that prohibits conversion to fixed rate debt. However, banks are understandably reluctant to grant concessionary rates, and it is not clear in a falling interest rate environment that countries would benefit from such a change at market rates. Such considerations rather than accounting or regulatory problems are probably the main barrier to wider use of "innovative approaches".

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM WILLIAM TAYLOR

Question 1

When Secretary of Commerce Baldridge testified before the Banking Committee on May 14 he said if a commercial bank has a problem loan, and would like to write it off at 10 percent a year for 10 years, it would not be allowed to do so by bank regulators. He said once a bank admits that a loan is not good it has to write off 100 percent of it at once or else immediately set up a debt reserve equal to the size of the loan.

Is that accurate? What do you think of Secretary Baldridge's proposal? What are the pros and cons of such a proposal for bank safety and soundness? Are there ways for our banks to write-off these LDC loans over a period of years?

Answer

To date the regulatory agencies have not mandated a loss classification, which would require full charge-off, for any sovereign credits. Basically under the interagency definitions loss classification is reserved for cases of debt repudiation. Instead, severe problem credits are classified value impaired and handled under the ATRR system. Under these procedures the agencies evaluate the credits annually and determine what portion of the credit needs to be specifically reserved against(or at the bank's option charged-off). The first year reserve has generally been in the range of 10-15 percent of outstandings. Increases after the first year have ranged from 0-25 percent depending on the previous size of the reserve and the circumstance affecting debt service.

As the above indicates, the regulatory system does not cause problems of the type referred to by Secretary Baldridge. If, however, a bank management on its own determines that there is a loss in the portfolio, accounting rules require that the bank charge-off in the current period any amount identified as a loss. However, a bank is not prevented from determining that only a portion of a given loan is a loss and that remaining amounts are collectable.

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PROXMIRE--TAYLOR

Question 2

Dr. Karin Lissakers testified on June 25 that while the banks are generally better off vis-a-vis the international debt problem than they were in 1982, the LDC debtor countries are no better off or even worse off than when the crisis broke. She noted that the Latin American debtor nations have paid out more than $130 billion in interest since 1982, only to find themselves $50 billion deeper in debt.

In contrast you testified that over the past three years the Baker Plan countries have decreased their overall indebtedness by almost one-half billion dollars.

Could you list each of the 15 Baker Plan countries and give us each country's total indebtedness over each year from 1982 through 1986?

Could you also furnish the amount of interest each country has paid on its total debt annually since 1982. Finally please provide the amount of money each such country has owed to U.S. banks over each of the last four years and the amount of interest they have paid each year to U.S. banks.

Answer

The attached tables present estimates of total indebtedness and scheduled interest payments, and indebtedness to U.S. commercial banks, for the so-called "Baker 15" countries over the period 1980-85. It should be emphasized with respect to the first two tables that they include staff adjustments of publicly available data and thus are indicative and not definitive. As can be seen from the attached tables, total interest payments to all creditors, including commercial banks, are estimated to have risen sharply from 1980-82, and to have declined slightly since despite an increase in the indebtedness of these countries over the period. Interest payments are expected to continue to fall in 1986.

We do not maintain a time series of scheduled interest payments to U.S. commercial banks. Such a series would be difficult to estimate based upon aggregate data on interest payments because the currency composition and other characteristics of the borrowing countries' debt differ across various classes of creditors.

TABLE 1

GROSS EXTERNAL DEBT OF BAKER 15 COUNTRIES
($ billions)

	1980	1981	1982	1983	1984	1985e
Argentina	27.2	35.7	43.2	46.0	47.8	49.5
Bolivia	3.2	3.7	3.8	3.8	4.0	4.4
Brazil	69.1	75.1	88.4	92.6	102.0	102.8
Chile	11.1	15.5	17.2	17.4	18.9	19.7
Colombia	6.3	7.9	9.4	10.4	11.5	12.8
Cote d'Ivoire	5.9	6.7	7.9	7.6	7.4	7.3
Ecuador	5.6	7.3	7.6	8.1	8.3	8.6
Mexico	57.7	79.2	88.6	93.8	96.4	97.5
Morocco	8.0	9.5	12.4	12.6	13.6	14.9
Nigeria	9.0	11.9	14.2	19.7	19.4	19.3
Peru	9.6	9.7	11.3	12.4	13.4	13.7
Philippines	17.2	20.3	23.8	24.7	25.5	26.3
Uruguay	2.2	3.2	4.4	4.6	4.7	4.9
Venezuela	18.3	38.5	41.5	40.4	38.8	38.1
Yugoslavia	19.1	19.9	20.0	20.5	20.2	20.3
Total of Above	269.5	344.2	393.7	414.8	431.9	440.1

Sources: Country sources, IMF; e: Estimate.

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TABLE 2

GROSS INTEREST PAYMENTS OF BAKER 15 COUNTRIES 1/
($ billions)

	1980	1981	1982	1983	1984	1985e
Argentina	2.2	3.8	4.9	5.4	5.5	5.2
Bolivia	0.3	0.3	0.4	0.3	0.3	0.3
Brazil	7.3	10.5	12.6	10.3	11.4	11.7
Chile	1.1	1.8	2.1	1.8	2.2	2.0
Colombia	0.6	0.9	1.1	1.0	1.2	1.3
Cote d'Ivoire	0.6	0.7	0.8	0.7	0.8	0.7
Ecuador	0.6	0.9	1.2	0.7	0.9	0.9
Mexico	5.4	8.4	12.2	10.2	11.7	9.9
Morocco	0.7	0.8	0.7	0.6	0.6	0.6
Nigeria	0.4	0.5	0.6	1.0	1.2	1.4
Peru	0.7	1.0	1.0	1.1	1.2	1.3
Philippines	1.6	2.3	2.4	2.1	2.2	2.5
Uruguay	0.2	0.2	0.3	0.3	0.4	0.4
Venezuela	3.1	4.0	3.7	3.7	4.1	3.5
Yugoslavia	1.7	2.0	1.9	1.9	1.8	1.8
Total of Above	26.4	38.2	46.0	41.3	45.5	43.4

Sources: Country sources, IMF; e: Estimate.

1/ Scheduled interest payments for all except Nigeria, which is interest estimated to have been paid.

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TABLE 3

U.S. BANK CLAIMS ON BAKER 15 COUNTRIES
($ billions)

	1980	1981	1982	1983	1984	1985e
Argentina	6.9	8.4	8.2	8.5	8.0	8.4
Bolivia	0.5	0.4	0.4	0.3	0.2	0.1
Brazil	14.5	16.8	20.4	20.7	23.9	22.8
Chile	3.7	5.8	6.1	6.2	6.7	6.6
Colombia	2.7	2.8	3.2	3.3	3.0	2.6
Cote d'Ivoire	0.5	0.7	0.6	0.5	0.5	0.4
Ecuador	1.9	2.1	2.0	2.1	2.1	2.1
Mexico	15.7	21.5	24.4	26.3	26.5	24.9
Morocco	0.7	0.8	0.8	0.9	0.9	0.9
Nigeria	0.9	1.1	1.9	2.1	1.5	1.2
Peru	1.7	2.0	2.5	2.5	2.4	1.7
Philippines	4.6	5.4	5.7	6.1	5.5	5.4
Uruguay	0.4	0.6	0.9	1.0	1.1	0.9
Venezuela	9.7	10.5	11.6	11.3	10.8	10.1
Yugoslavia	2.4	2.7	2.3	2.4	2.4	2.4
Total of Above	66.8	81.5	91.1	94.2	95.4	90.5

Source: Country Exposure Lending Survey; e: Estimate

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Question 3

During our June 25 hearing it became clear that there are differences of opinion between the more exposed and the less exposed banks about how each should deal with their exposure in various LDC countries. Mr. Haswell of the Chemical Bank noted, for example, that the less exposed banks might well prefer to write the debt off while those with more exposure could not afford to do that.

Is that true? Are the bank regulators or the larger exposed banks exerting any pressure on the smaller, less exposed banks to go along with the Baker Plan by lending new money? Is there any effort being made by the regulators or big banks to prevent the smaller banks from writing off, reducing interest on, or selling off their LDC debt.

Answer

Some banks have charged-off small exposures to countries other than those for which the banking agencies have mandated an ATRR. This may have been done for a variety of reasons. Also, it does not mean that the banks are uninterested in collecting the debt. Other banks have sold or swapped out of small exposures to LDCs. This has often been done because the small exposures did not warrant the management time that had to be devoted to restructurings. However, despite sales, swaps, and charge-offs, the LDC debt problem is not exclusively a large bank problem.

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PROXMIRE--TAYLOR

For example, about 40 U.S. banks, including regional and community banks, have exposure to Mexico that exceeds 25 percent of capital.

While the Federal Reserve has expressed this general support for the Baker initiative, Federal Reserve bank regulators have not pressured banks with regard to restructuring or new lending decisions. The positions of the various banks with regard to a rescheduling are worked out among the banks in the negotiating process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM WILLIAM TAYLOR

Question 1

As it stands now, banks are able to address the problem of lower-quality assets, concentrated in Latin American countries, through the Allocated Transfer Risk Reserve.

Could that approach be expanded? Should it?

Does the quality of the loans owed to U.S. banks warrant an expansion of the Allocated Transfer Risk Reserve?

Answer

The Allocated Transfer Risk Reserve (ATRR) applies to credits where there are protracted arrearages in debt service, generally where interest payments have not been met over a significant period of time. In these circumstances a specific reserve or a charge-off appears to be warranted (in fact, most banks take a partial charge-off rather than establish a specific reserve). In my view this treatment should not be applied to credits where interest is being kept current, which is the case for most of banks' LDC credits. Rather, it appears to me that the sizable LDC portfolios of some banks represent a general but non-quantifiable risk that can best be accommodated through an increase in general resources of a bank, either capital or general loan loss reserves, rather than through establishment of specific reserves. It seems to me that the experience over the last few years also supports such a general reserves approach to the problem of large LDC portfolios. A couple of years ago most of the concern was whether some of the oil importing countries would be able to continue to service their indebtedness. Now concern is focused primarily on the oil exporting countries. Moreover, during the 1982-86 period taken as a whole, domestic credit problems have resulted in more losses than LDC credits. Since it is not possible in most cases to correctly identify which country credits if any, might result in a loss, rather than tying reserves to specific credits, it seems advisable for banks to build capital and general loan loss reserves to meet possible future problems on international or domestic credits, in what is clearly a riskier world. This is what the agencies have been encouraging the banks to do through such programs as minimum capital adequacy requirements.

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SASSER--TAYLOR

Question 2

I understand that European banks are characterizing this debt problem as a U.S. bank problem.

How have they arrived at that conclusion?

What impact is their policy of writing down L.D.C. loans having on U.S. banks?

Answer

Available data indicate that U.S. banks account for about 35 percent of the commercial bank lending to the 15 countries named in the Baker Initiative. Thus, the LDC lending problem is clearly not just a U.S. bank lending problem.

Unlike U.S. banks, European banks generally do not disclose their significant exposures to countries, so it is not possible to precisely determine their exposure. It does appear though that in some European countries exposure to particular Latin American borrowers may be considerably less than for U.S. banks, as banks in these countries devoted proportionately more lending toward Africa or Eastern Europe. Banks in some countries have also been able to receive a tax benefit for writing-off portions of their LDC loans. However, while the impact on various banks due to any defaults by particular debtor countries may vary, the aggregate data indicates that banks in many countries would be seriously affected by general deterioration in the LDC debt situation.

Differences in relative exposure and in charge-off policies do not seem to have caused significant obstacles to dealing with the LDC debt problem. Banking groups in all of the major European countries have expressed support for the Baker Initiative. European banks are important representatives on the debt restructuring committees and to date have supported the existing process for dealing with the problem.

Question 3

In the Joint Economic Committee on June 24th, a witness quoted Helmut Schmitt as saying he felt that Latin American debts are largely uncollectible.

Do you agree with that conclusion?

To the degree that they are, at least in part, collectible, what is preventing the banks from reducing the threat unilaterally, from participating in the Baker plan?

To the degree that loans are not collectible, what is preventing the banks from recognizing that fact in the computation of the quality of their assets?

Answer

At this point I would not agree that Latin American debts are largely uncollectible. It is difficult to argue that economic adjustment and progress is not taking place in the major LDC borrowers. Since 1982, the following positive factors have occurred: (i) consumer price inflation is down (ii) public sector deficits as a percentage of gross domestic product are declining; (iii) trade surpluses have increased; (iv) current account imbalances have declined substantially; and (v) there has been a healthy increase in total reserves. The problem is that some observers would argue that this progress is not sustainable over a long period of time and that this progress has been obtained through a general decline in living standards that bears a high social cost. This is probably true. But Secretary Baker's proposal is an acknowledgement of this problem and represents a reasonable attempt to find a solution. It will take considerable time and continuing efforts to resolve finally this seemingly intractable problem. Nonetheless, I believe sufficient progress is being made, albeit slowly, that would argue against assuming that loans to Latin American countries are uncollectible.

I am not aware of any problem that is preventing the banking system from participating in the Baker Initative.

I am not aware of any fact that would inhibit bank management from determining a loan is not collectible and writing-off the balance.

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SASSER--TAYLOR

Question 4

How would you characterize the distinction between the implications of "writing off" a loan and "reserving against" a loan?

What role does any distinction have in resolving the problems associated with Latin American debt?

Answer

Banks are required to write-off a loan or any portion of a loan that is considered uncollectible. The categorization of loss does not imply that there is no recovery or salvage value, but rather that it is not practical to defer writing off the asset even through partial recovery may be effected in the future. At times a bank may specifically reserve against a loan which accomplishes the same objective. Failure to write-off loans that are considered loss distorts the balance sheet by overstating loans and overstating loan loss reserves.

In addition to actually recognizing a loan as a loss, banks are also required to maintain a reserve that is sufficient to cover the latent loss potential in the loan portfolio. Bank management must review the quality of its loans at least quarterly and make whatever adjustments are necessary to the reserve account to reflect the expected loss potential inherent in the loan portfolio. There is a considerable amount of subjective judgment involved in determining the proper level of loan loss reserves, including evaluation of such factors as a bank's loan loss history, concentrations within the loan portfolio, management, and economic variables. Usually, the term "reserving against" a loan refers to the fact that the bank has increased its general loan loss reserve to account for the amount of potential loss in a loan. When the loan or any portion of the loan actually becomes uncollectible it is required to be written-off by reducing both the loan portfolio and the reserve for loan losses.

The distinction between "writing off" a loan and "reserving against" a loan really has no role in resolving the problems associated with Latin American debt. Banks are required to write-off uncollectible loans and also to reserve properly against potential future loan losses.

Question 5

Please respond to the estimate that in the next 10 years, one-third of the regional Latin American debt of $380 billion will have to be written off.

Answer

I would think that it is premature to conclude that one-third of the Latin American debt will have to be written off. Most of the major LDC borrowers are making progress in pursuing economic adjustment measures that would hopefully lead to an unquestioned ability to service outstanding contractual debt. Ten years is a long time over which to speculate whether or not the LDC debt will be repaid.

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SASSER--TAYLOR

Question 6

According to many estimates, for a free economy to survive, its debt-to-gross domestic product ratio cannot be higher than 25 percent. In the case of Mexico, with a $100 billion debt and a gross domestic product of $175 billion, the ratio is 60 percent. Chile's is at 120 percent, Brazil at 40 to 45 percent. Argentina at 70 percent.

In view of these ratios, the comment was made in testimony yesterday that it is, quote, "the utmost folly," unquote, to be increasing the debt.

How would you respond to that?

Does increasing debtor nation's debt actually contribute to their credit-worthiness?

Answer

Increasing moderately the debt of countries can contribute to their creditworthiness when done in the context of comprehensive programs aimed at stabilization and structural reform. Such an approach is what is envisaged under the Baker Initiative. Moreover, debt or debt service relative to GDP (or exports) can fall when debt or debt service is rising, as long as GDP (or exports) is rising faster. Indeed, for many countries, these ratios have fallen from peak levels over the last few years.

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SASSER--TAYLOR

Question 7

What kind of innovations have you seen among debtor nations for stemming capital flight?

I'm interested in your assessment of, for example, debt-equity swaps, financial investment structures, and other initiatives designed to reduce debtors' need for new loans.

What recommendations have you made, and what would you like to see done?

Answer

The Federal Reserve Board has not made any recommendations or judgments as to the usefulness of these financial innovations as instruments for reversing capital flight. Curing capital flight depends first and foremost upon the implementation of sound, credible economic and financial polices by the country that will serve to restore confidence in the government. A stable environment, with sustainable economic growth and an adequate regard for economic incentives--including realistic rates of return on domestic savings and a realistic exchange rate--is needed if a country is to retain at home its domestically generated private sector capital. When good policies are in place, confidence of a country's own citizens and of foreign creditors will return.

Even if capital flight is reversed, many LDCs will continue to need external investment to reach their growth potential. In this context, borrowers, creditors and potential foreign investors may want to explore new financing mechanisms that are mutually acceptable and may help to channel foreign fund to LDCs other than through the conventional lending process.

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SASSER--TAYLOR

Question 8

Testimony was received in the Joint Economic Committee this week to the effect that the definition of the problem is wrong, that we need to get the debt problem "off center stage" and focus on restructuring...not short-term liquidity.

Do you agree that short-term liquidity is a misplaced focus in this debate? How do you go about restructuring without harming U.S. manufacturing and agriculture?

Answer

The Baker Initiative envisages moderate amounts of new lending over the next several years in order to support borrowers' plans for structural adjustment and growth. Its focus is not on short-term liquidity problems. Nevertheless, short-term liquidity problems cannot be ignored when they arise; mechanisms must exist to ease such problems in the context of longer-term programs.

The Baker Initiative encourages countries to pursue economic policies that are competitive and market-oriented. The objective is not to reduce further the current account deficits or to expand further the trade surpluses of the heavily indebted countries as a group. Rather the objective is to establish the conditions under which both their exports and their imports can expand. Although adjusting countries may export more, they will import more as they achieve sustained growth. On balance, the United States could be expected to benefit from such developments, and the agricultural and manufacturings sectors, are likely to share in any increased demand for exports.

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SASSER--TAYLOR

Question 9

What is the effect on bank stock prices of acknowledging that the quality of some of the assets associated with lending to these debtor nations has fallen to below par value?

Haven't there been recent instances where the prices have actually risen in response to a bank's public recognition of reality?

Answer

It is difficult to predict market behavior. It is generally believed, however, that sophisticated market analysts do make conservative estimates of the impact future loan losses may have on the earnings stream of a financial institution. This estimate may overstate or understate the degree to which the earnings stream is effected.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM ROBERT R. BENCH

Question 1

The $90 billion of LDC debt held by U.S. banks that is rated as troubled (in the OTRP category or below) compares to $105 billion of total capital for those banks. Doesn't this argue for significantly stronger reserve positions and higher capital requirements for banks with heavy exposure to troubled LDC debtors than for other banks? Can a pattern of higher capital and LDC exposure be demonstrated?

Answer

The amount of troubled LDC debt held by U.S. banks doesn't necessarily mean that banks must have higher capital levels. For instance, of the $90 billion of LDC debt rated as troubled, $85 billion or 94% is in the category of Other Transfer Risk Problems (OTRP). OTRP loans are those which have had an interruption of payment, but the borrowers are taking positive actions in restoring debt service, including the adoption of an IMF or similar economic adjustment program. We very much consider the amount of OTRP loans in determining the adequacy of banks' capital and reserves as well as in our discussions with banks' boards of directors. While these considerations may vary depending on the nature of facilities comprising the exposure, we generally expect national banks to incorporate OTRP exposures in their capital and reserve planning.

The data demonstrate a pattern of increasing capital and reserves in U.S. international banks, thereby reducing those banks' vulnerabilities to the international debt situation. As I related in the text of my testimony on June 25, the primary capital in 24 of our largest banks has risen $19 billion since 1982 when the debt crisis occurred. Since that time, the primary capital/asset ratios for these banks increased from 4.9% to 6.6%. These increases in capital, coupled with modest additional lending to LDCs, have significantly lowered U.S. banks' exposure. The nine U.S. money center banks decreased their LDC exposures from 209% of capital to 148% since 1983, including a decrease in Latin American exposure from 163% to 124%. I understand the Federal Reserve and FDIC also have submitted data demonstrating similar patterns of higher capital vis-a-vis LDC debt.

Question 2

The Baker Plan calls for the extension of new credits to many of the nations where loans are already unfavorably categorized. These same countries have made little progress toward greater debt service despite repeated reform efforts.

How can a new loan not be classified when loans existing on the books are classified. Should not these new loans be carried at less than 100% of face value to reflect the risk that is already recognized in other loans to the same country?

Answer

The U.S. Debt Initiative calls for three things: first and foremost, a country's adoption of growth oriented economic reforms; second, enhanced and more effective multilateral finance to support such adjustment; and third, net new lending from international banks.

Thirteen of the 15 countries included in the Debt Initiative are categorized as either OTRP or Substandard. These categories indicate that the loans have had some debt service problems and represent higher risks. However, progress toward the restoration of debt service is being made through reform efforts. Many of these countries have restored their liquidity, tempered internal inflation, and improved the external sectors of their economies. The two other countries are categorized as Value Impaired because their loans are in a protracted state of arrears caused by a failure to adopt sound economic adjustments. These loans are carried on the banks' books at considerably less than 100% face value, since we have mandated Allocated Transfer Risk Reserves (ATRRs) against them.

As we testified before the Committee in early 1983, the purpose of our categorization scheme is to reflect degrees of risk generally based on degrees of non-performance. While we have no policy of making a distinction between new and old loans in the OTRP and Substandard categories, new lending, tied to a credible economic adjustment program and multilateral assistance, can strengthen the quality of all loans to a given country and be the catalyst for upgrading the old loans. We do make a distinction between new and old loans to a Value Impaired country. Since 1982, new loans (generally essential trade credits) have been serviced properly, classified Substandard and an ATRR has not been imposed. Should these new credits become chronically delinquent, then they would be classified Value Impaired as well, and an ATRR would be considered. Finally, our categorization policies are sufficiently flexible to allow for distinctions of particular new or old credit facilities, such as trade credit, which may not experience debt service problems. Generally, these special facilities may be accorded a lesser categorization.

Question 3

ILSA requires that countries that are delinquent in their debt servicing payments and who have not taken adequate measures to restore repayment prospects through economic adjustments must write down their loans through an Allocated Transfer Risk Reserve (ATRR). Despite the large volume of LDC debt rated as troubled, imposition of special reserves by regulators has been very limited, leaving banks to decide on the appropriate reserves for most LDCs. Only $2.4b of loans are covered by ATRRs. Since so much LDC debt is questionable, and the banks are now in a stronger position to handle write-downs, shouldn't the regulators more aggressively pursue the creation of ATRRs?

Answer

I would not agree that so much LDC debt is questionable. Many LDCs have become delinquent at some time during the past four years. However, just about all of them have adopted economic adjustment programs, restored their liquidity and eliminated their arrears. We currently categorize seven countries as Value Impaired. These are countries which have had a protracted inability to take economic adjustment measures and service their external debt. This criteria is consistent with ILSA. As discussed previously, we also continually expect banks' boards of directors to strengthen capital and reserves against their increased exposures categorized as OTRP and Substandard, consistent with ILSA.

Question 4

From our discussion at the hearing, it is clear that there is a growing recognition that some LDC debt is not worth its full face value. A secondary market is trading the debt of a variety of countries at a discount; some banks are writing down LDC debt, and you the regulators are mandating reserves for selected countries. Yet, even where debt is being written-down, little of the benefit of reduced debt service is received by the LDCs.

Why shouldn't regulators be taking a more accommodative stance toward debt settlements arranged between the bank and LDC creditors involving modification of terms on troubled debt and/or acceptance of assets in lieu of cash (equity, securities, goods, real estate, etc.)? What are the benefits or problems of applying the guidelines of FASB-15 and general regulatory forebearance to the LDC debt problem?

Answer

This Office takes a generally neutral stance on negotiations between the banks and the debtor countries. We cannot intervene on contracts between lenders and borrowers as long as they are in compliance with U.S. banking laws and supervisory policies. Only the lender has the power to forgive a debt. The absence of such forgiveness indicates the banks' expectations that most LDCs eventually will pay. In this regard, I do not believe the secondary market for LDC debt is a good indicator for many countries' abilities to ultimately repay. That market is very imperfect. Volume is minimal; there is no breadth or depth to the market or a primary market maker. There also is no homogeneity to the instruments being traded. They vary by various characteristics. This demand and supply rests on various factors, only one of which is an assessment of creditworthiness.

Existing law, regulation, and supervisory policy allow for a range of loan negotiations as well as some transformation of loans into other financial assets, including local currency assets (such as equities and real estate) which can lessen debt service burdens. Should our policies pose an impediment to certain loan negotiations or other financing proposals, we would review these policies and modify them accordingly, consistent with our key prudential and accounting principles as well as our systemic concerns. Mr. Collier of the FDIC, in his letter to you dated August 8, 1986, detailed the problems of applying FASB-15 to LDC debt. The rules are very complex, statements about their general application are difficult to make, and proposals must be reviewed pretty much on a case-by-case basis.

Question 5

A number of innovative approaches toward international lending which provide debt relief to LDC borrowers are being developed: debt-equity swaps, conversion of debt into long term securities, interest payable in local currency, with possible later conversion to foreign exchange.

How should these specific approaches be handled by regulators and accountants? Are banks scared away from these innovations by regulatory treatment, or is the current regulatory framework supportive of institutions passing along debt relief to the countries. What are the legal, accounting impediments?

Answer

I support exploring these innovative approaches. They might be used to reduce debt service requirements as well as some of the stock of debt. Transformation of LDC bank loans into other assets might also provide LDCs with a more prudent blend of external finance to support their development. Transformation can be a positive solution for both the lending bank and the LDC. The Treasury in recent speeches has indicated to banks that these ideas for new financing approaches are worthy of their exploration and consideration.

I don't believe banks are scared away from these innovations by U.S. regulatory treatment. As I indicated in the response to the preceding question, existing U.S. bank regulatory and accounting policies generally allow for innovative approaches. They are not impediments to them. Rather, the banks are cautious primarily because of legal and economic conditions in the developing countries as well as their concerns for making the right investment. For instance, foreign debt for equity swaps is not a normal activity for U.S. banks. Unlike their European or Japanese counterparts, holding foreign equities is generally not part of U.S. banking culture. Furthermore, transforming a dollar denominated loan for a local currency asset raises profitability issues such as foreign exchange translation losses or blocked dividends. While many LDCs are modifying their legal framework to promote foreign investment, U.S. banks remain concerned about these new, evolving, and untested policy changes. In many countries, good investments remain scarce because so many firms are nationalized or some countries limit foreign banks' investments to certain terms and sectors. For instance, a U.S. bank might not be allowed to acquire a controlling or sizeable investment in an indigenous financial service firm. Overall, the major impediment to U.S. banks participating in innovative approaches, in my view, is the lack of investment opportunities that satisfy both the U.S. bank and the developing country.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ROBERT R. BENCH

Question 1

At our June 25 hearing, you told us that there are seven countries that the regulators have categorized as Value Impaired and that $3 billion of the $5 billion has been written-off. Can you give us the names of those seven countries and the amount of loans our banks have written off to each? Can you also indicate over what time period the remaining $2 billion will be written off?

Also provide for the record a list of the 15 countries that are included in the Baker Initiative, the exposure of U.S. banks in each of the 15 countries, and how each of these countries is classified by the bank regulators.

Answer

In late 1983 the Federal banking agencies adopted a new system of transfer risk classifications in compliance with ILSA. The "Value Impaired" classification is applied to those countries which: a) have not fully paid their interest for six months; b) have not complied with an IMF program (and for which there is no immediate prospect of compliance); and c) have not met rescheduling terms for over one year. Since the adoption of the classification, 7 countries have met those criteria, been rated Value Impaired, and subjected to an Allocated Transfer Risk Requirement (ATRR). The current ATRR varies between 30 and 90 percent of outstandings to the country.

In the approximately three years since the implementation of the ATRR, the total outstandings of U.S. banks to countries rated as Value Impaired has declined by 47 percent to approximately $2.1 billion as of 3/31/86. It is impossible to predict when (or even if) the remaining $2.1 billion will be required to be reserved. Although the level of the ATRR for each country is reviewed at least annually, and is generally increased in increments of 15 percent per year, the annual increase in the ATRR may in some cases be either more or less than 15 percent, depending on the borrowers' condition.

It is the policy of the Federal regulatory agencies that our supervisory classifications of borrowers not be publicly disclosed. The following table summarizes the total direct outstandings of U.S. banks as of 3/31/86 to the 15 countries included in the Baker Initiative.

	(Millions $)
Argentina	$ 8,700
Bolivia	97
Brazil	25,406
Chile	6,433
Colombia	2,273
Ecuador	1,978
Ivory Coast	428
Mexico	24,182
Morocco	801
Nigeria	824
Peru	1,379
Philippines	5,535
Uruguay	892
Venezuela	9,696
Yugoslavia	2,058
	$90,682

Question 2

When Secretary of Commerce Baldridge testified before the Banking Committee on May 14, he said if a commercial bank has a problem loan, and would like to write it off at 10 percent a year for 10 years, it would not be allowed to do so by bank regulators. He said once a bank admits a loan is not good, it has to write-off 100 percent of it at once or else immediately set up a debt reserve equal to the size of the loan.

Is that accurate? What do you think of Secretary Baldridge's proposal? What are the pros and cons of such a proposal for bank safety and soundness? Are there ways for our banks to write off these LDC loans over a period of years?

Answer

The Secretary's statement generally is accurate. Whenever a loan, in whole or in part, is considered a loss, U.S. Generally Accepted Accounting Principles (GAAP) require that the write-down be taken during the accounting period in which the loss is recognized.

We considered proposals to amortize losses during our policy development on forebearance for agricultural as well as oil and gas loans. We rejected the idea since it was contrary to GAAP. Instead, we adopted a policy calling for capital forebearance.

Throughout the development and implementation of ILSA we have confined our definition of loss to only those countries which formally repudiate their debt. None have in recent years. However, ILSA also provides for reserving or writing-down LDC loans periodically. Under ILSA, protracted problem credits are classified as Value Impaired and annually the agencies mandate an Allocated Transfer Risk Reserve (ATRR) against those credits. Alternatively, the banks may write down the loans in the amount of the ATRR. The level of the reserve generally is 10-15 percent the first year. Additional increments have been imposed in subsequent years ranging from 0-25%, depending on the degree of deterioration, if any, in the asset.

Question 3

During our June 25 hearing it became clear that there are differences of opinion between the more exposed and the less exposed banks about how each should deal with their exposure in various LDC countries. Mr. Haswell of the Chemical Bank noted for example that the less exposed banks might well prefer to write the debt off while those with more exposure could not afford to do that.

Is that true? Are the bank regulators or the larger exposed banks exerting any pressure on the smaller, less exposed banks to go along with the Baker Plan by lending new money? Is there any effort being made by the regulators or big banks to prevent the smaller banks from writing off, reducing interest on, or selling off their LDC debt?

Answer

We strongly believe that banks' portfolio decisions are the responsibility of banks' directors and management. They must decide what is in the best interests of their institutions and shareholders. In terms of international debt, those decisions vary from bank to bank depending on many factors, not the least of which are strategic and marketing plans, as well as overhead considerations. For these reasons, some small international lenders have charged-off or sold their modest LDC exposures. Some larger lenders have consolidated exposures through swaps to reduce overhead expenses. Big international lenders seem to remain very active in all phases of international finance, including financial innovations for LDCs.

The OCC has supported the International Debt Strategy since 1982 and we now support the Baker Initiative. Throughout this support, we have never exerted any pressure on any bank about their portfolio decisions. I am not aware of larger exposed banks preventing smaller banks from writing-off, reducing interest on, or selling off their LDC debt. The terms of new money packages and debt reschedulings are established through negotiations among banks and between the banks and their borrowers.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM ROBERT R. BENCH

Question 1

As it stands now, banks are able to address the problem of lower-quality assets, concentrated in Latin American countries, through the Allocated Transfer Risk Reserve. Could that approach be expanded? Should it? Does the quality of the loans owed to U.S. banks warrant an expansion of the Allocated Transfer Risk Reserve?

Answer

I do not believe we need to expand the criteria for imposing an Allocated Transfer Risk Reserve ("ATRR") at this time. The present policy calls for an ATRR or write-down when a borrower clearly demonstrates a protracted inability to: service debt, adjust its economy, or remain in substantive compliance with overall financing arrangements. This is not the situation for most debtor countries. They are not in arrears, or substantively out of compliance. Granted, over the last four years, one country or another has become a temporary problem because of delay in political-economic decision making or the need to adjust to some external shock. However, in the short-term each country returned to regular debt service. Overall, if we expanded the ATRR criteria, we could very well whipsaw banks' balance sheets, for instance, by requiring a reserve against country X today, and then reversing ourselves in six months. However, the ATRR is not the only means for recognizing higher risks. Consistent with our policies for domestic loans, we have promoted an expansion of the general loan loss reserve and increases in banks' capital to address the latent, basket of risks in U.S. banks' international portfolios. As I indicated in my text on June 25, U.S. banks continue to strengthen their balance sheets and reduce their vulnerability against the general uncertainties of LDC loans.

Question 2

I understand that European banks are characterizing this debt problem as a U.S. bank problem. How have they arrived at that conclusion? What impact is their policy of writing down LDC loans having on U.S. banks?

Answer

The characterization is difficult to understand given the interdependent world we live in. The debt problem relates directly to the health of the international trading system, in which European banks have a large stake. Furthermore, European banks reportedly hold about one-third of all LDC debt while North American and Japanese banks also each hold about a third.

Granted, the European banks' exposure may be more oriented to Comecon and Africa while U.S. and Japanese banks are oriented to Latin America and Asia, but the debt problem clearly is a communal one for the international banks of the world. Because of this interdependence, there has been no considerable impact on U.S. banks from the policies of some European banks of writing-down LDC loans. Those policies, by the way, differ from country to country, depending on local tax and accounting conventions as well as differing assessments of LDC creditworthiness. The incompatibility of some of these factors vis-a-vis banks in North America, Japan, and the United Kingdom may have to be considered during negotiations among the banks, however, European banks have pledged their support for the Baker Initiative and have been full partners since 1982 with U.S. and other international banks in arranging new loans and debt reschedulings for LDCs.

Question 3

In the Joint Economic Committee on June 24th, a witness quoted Helmut Schmidt as saying he felt that Latin American debts are largely uncollectible. Do you agree with that conclusion? To the degree that they are, at least in part, collectible, what is preventing the banks from reducing the threat unilaterally, from participating in the Baker Plan? To the degree that loans are not collectible, what is preventing the banks from recognizing the fact in the computation of the quality of their assets?

Answer

I believe that most U.S. banks' loans to Latin America are being restored to orderly debt service and are collectible over time. However, at present, a few countries do not demonstrate an ability to repay, have been classified Value Impaired and are being written-down. In addition, U.S. banks' loans to private sectors throughout Latin America include uncollectible situations which are being classified and/or written-off in the same way that any domestic commercial loans are treated.

As I stated in my testimony on June 25, a great deal of progress has been made since the international debt strategy began in 1982: deficits and inflation have been reduced; trade positions and current account positions have improved; liquidity has been restored; and, there has been a general return to orderly debt service. The enhancement of the strategy with the Baker Initiative provides a foundation of sustained growth for many of these countries and their return to voluntary lending arrangements over time.

As you know, the Debt Initiative calls for economic growth oriented reforms from the debtor countries, enhanced and more effective lending from the multilateral institutions, and net new financing from the commercial banks. The international banks are participating in this Initiative. They have pledged their support for it, including new loans. They have continued to reschedule loans of countries included in the Initiative. However, they have yet to lend much money under the Plan because the countries, until the recent Mexican request, have not asked the banks for new loans. I have no reason to suspect that the banks will not honor their pledge to support the Baker Initiative.

SASSER--BENCH

Question 4

How would you characterize the distinction between the implications of "writing off" a loan and " reserving against" a loan? What role does any distinction have in resolving the problems associated with Latin America debt?

Answer

Banks maintain a loan loss reserve into which they make provisions from earnings (reserving) adequate to cover latent risks as well as specific potential losses. Should the potentially identified loss become an actual loss, or should a surprise loss occur, the loan portfolio and reserve are reduced by the amount of the loss, effecting a write-off. A technical distinction between reserving and write-off in a U.S. context is that increases in loss reserves add to U.S. banks' primary capital as defined by the banking agencies. Reductions in the reserve reduce primary capital. Reserving and/or writing-off are means used by banks to cushion and resolve degrees of a problem in their portfolio. They have no role in resolving the debt problem for the Latin American borrower.

Question 5

Please respond to the estimate that in the next 10 years, one-third of the regional Latin American debt of $380 billion will have to be written off.

Answer

It is reasonable to assume that out of a stock of $380 billion, losses will occur over the next decade from loans to the private sector and perhaps some public sector borrowers. However, the general economic adjustment and progress being achieved by the majority of Latin nations in recent years makes it difficult to concur with the magnitude of the estimate.

Question 6

According to many estimates, for a free economy to survive, its debt-to-gross domestic product ratio cannot be higher than 25 percent. In the case of Mexico, with a $100 billion debt and a gross domestic product of $175 billion, the ratio is 60 percent. Chile's is a 120 percent, Brazil at 40 to 45 percent. Argentina at 70 percent.

In view of these ratios, the comment was made in testimony yesterday that it is, quote, "the utmost folly", unquote, to be increasing the debt. How would you respond to that? Does increasing debtor nations' debt actually contribute to their creditworthiness?

Answer

The international debt strategy since 1982 has emphasized collective agreement among debtor nations, creditor governments, multilateral institutions and the global community of banks that additional new lending in conjunction with comprehensive economic structural adjustment can strengthen the creditworthiness of debtor countries. As long as the new loans are used to generate new resources and export earnings, creditworthiness should improve.

Question 7

What kind of innovations have you seen among debtor nations for stemming capital flight? I'm interested in your assessment of, for example, debt-equity swaps, financial investment structures, and other initiatives designed to reduce debtors' need for new loans. What recommendations have you made, and what would you like to see done?

Answer

Some developing countries are changing their macroeconomic policies to stem capital flight, underpin a repatriation of capital, and foster new foreign investment. These policy changes have been fairly orthodox and include reducing inflation and taxes as well as promoting interest rates that provide a real rate of return. In addition, many countries are revising their legal frameworks to remove impediments to foreign direct and equity investment.

Central banks and finance ministries in some countries are providing financial incentives to exchange external, hard currency debt for local currency assets. The extent of this activity so far appears to be nominal in dollar terms and in relation to the total stocks of international debt outstanding. However, it is an evolving phenomena generally dependent on specific negotiations between bankers and debtor countries as well as the environment created by the host government.

This Office has not made any recommendations or assessments about certain financial innovations between banks and debtor governments. However, I feel this evolving transformation of bank loans into other financial assets may: provide a better mix of foreign and repatriated capital; ease the stock of debt and the debt service burden, and help some lenders switch into higher quality financial assets. However, financial innovation poses different sets of risks for banks which must be managed. Losses can arise from the foreign exchange accounting translation of local currency assets into a dollar balance sheet. Earnings also can be reduced by local laws governing dividend restrictions. On balance, I welcome the banks and LDCs exploring innovative financial alternatives to resolving the debt problem.

[redacted]--BENCH

Question 8

Testimony was received in the Joint Economic Committee this week to the effect that the definition of the problem is wrong, that we need to get the debt problem "off center stage" and focus on restructuring -- not short term liquidity. Do you agree that short term liquidity is a misplaced focus of this debate? How do you go about restructuring without harming U.S. manufacturing and agriculture?

Answer

The international debt strategy begun in 1982 focused primarily on the restoration of liquidity in many LDCs. The reasons for the illiquidity and the strategy to correct it were discussed in depth with the Committee during 1983. Overall, the debt strategy was successful. Most countries adjusted their external sectors, rescheduled their debts, borrowed modest amounts in new loans, and restored their liquidity.

The Debt Initiative enhances that strategy by shifting the primary focus from liquidity to the adoption of economic reforms to achieve sustained economic growth. The Initiative includes medium-term new lending by the multilateral development institutions and commercial banks in support of these economic reforms and growth. However, that lending also serves to maintain countries' liquidity.

A key aspect to the Baker Initiative is its support for countries to bring their external and internal economic sectors better in balance. During the first phase of the debt crisis, countries were encouraged to promote exports and reduce their imports to sustainable levels in order to rebuild their foreign exchange reserves (liquidity). However, a side effect of this strategy was to reduce U.S. exports to LDCs. The U.S. Debt Initiative, by promoting internal economic adjustment and growth, should lead to less reliance on export-led economic growth and a growing but sustainable demand for imports from the United States.

Question 9

What is the effect on bank stock prices of acknowledging that the quality of some assets associated with lending to these debtor nations has fallen to below par value. Haven't there been recent instances where the prices have actually risen in response to a bank's public recognition of reality?

Answer

As a result of ILSA and regulatory policy, U.S. banks have significantly increased their capital and reserves as well as disclosures of their LDC loans. The marketplace has about all the information it needs to price banks' shares in light of LDC exposures. Generally, bank stock prices have increased in recent years in response to these disclosures as well as a variety of other reasons, including: increases in capital and reserves, increases in the quality and diversification of earnings, perceptions about future growth, and prospects for merger or acquisition activity.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM CHARLES COLLIER

Q.1. The $90 billion of LDC debt held by U.S. banks that is rated as troubled (in the OTRP category or below) compares to $105 billion of total capital for those banks. Doesn't this argue for significantly stronger reserve positions and higher capital requirements for banks with heavy exposure to troubled LDC debtors than for other banks? Can a pattern of higher capital and LDC exposure be demonstrated?

A.1. As of 12-31-85, total U.S. bank exposure to OTRP, Substandard, and Value Impaired countries was $85.4 billion, $2.1 billion, and $2.4 billion, respectively. The nine largest money center banks' share of this exposure represented 65% of all OTRP, 71% of Substandard, and 61% of Value Impaired exposures, indicating that these largest institutions account for the majority of criticized LDC exposure. The rate and the amount of primary capital growth for the nine money center banks has been higher than that for smaller institutions with less LDC risk. Money center bank holding companies' primary capital has increased by 29% since 12-31-83, for a total of 157 basis points.

In 1983, the nine money center bank holding companies' end of period primary capital ratios averaged 5.46%. Since 1983, the companies' primary capital has increased $19.6 billion, after charge-offs of $19.8 billion, for a total of $39.4 billion in gross capital injections. As of 3-31-86, their primary capital ratios averaged 7.03%. While the primary capital ratios of smaller institutions with less LDC exposure also improved, the increases were not as dramatic as those for the money center institutions; for example, between 1983 and 1985 the primary capital ratio for the 25 largest holding companies as a group increased from 5.75% to 7.06% or 131 basis points. Average primary capital ratios for other size bank peer groups further illustrate slower growth rates since 1983.

$ Total Assets	Basis Point Increase	% Growth Rate	3-31-86 Average Primary Capital Ratio
All insured banks	29	3	9.34
Between 3 bill. and 10 bill.	57	9	6.86
Between 1 bill. and 3 bill.	47	7	7.11
Between 500 mill. and 1 bill.	14	2	7.35
Between 300 mill. and 500 mill.	19	3	7.66
Between 100 mill. and 300 mill.	20	3	7.94

(Source: Federal Financial Institutions Examination Council Uniform Bank Performance Report)

In 1983, the primary capital levels of the largest institutions were comparatively low. Since that time, however, these institutions have made significant strides in improving their capital and reserve levels relative to their LDC exposure. Also, as I indicated in my testimony, country exposure has declined from 898% of capital for the nine money center banks as of year-end 1983 to 428% as of year-end 1985.

Q.2. **The Baker Plan calls for the extension of new credits to many of the nations where loans are already unfavorably categorized. These same** countries have made little progress toward greater debt service despite repeated reform efforts.

How can a new loan not be classified when loans existing on the books are classified? Should not these new loans be carried at less than 100% of face value to reflect the risk that is already recognized in other loans to the same country?

A.2. Only two of the 15 countries covered in the Baker Plan are classified Value Impaired and thus subject to ATRR requirements. Those two countries, to the best of our knowledge, are not receiving any new bank money and thus the question, from a practical standpoint, is moot. Hypothetically, new money to a country would not be subject to an ATRR. This was agreed to by the three Federal banking agencies and was included in the preamble to the implementing regulations. The reasoning was that new money advanced by the banks would presumably be in conjunction with a viable economic adjustment program and would result in improvement in the country's financial strength. Therefore, ATRR's would not be required for the new money.

Q. 3. ILSA requires that countries that are delinquent in their debt servicing payments and who have not taken adequate measures to restore repayment prospects through economic adjustments must write down their loans through an Allocated Transfer Risk Reserve (ATRR). Despite the large volume of LDC debt rated as troubled, imposition of special reserves by regulators has been very limited, leaving banks to decide on the appropriate reserves for most LDC's. Only $2.4 billion of loans are covered by ATRRs. Since so much LDC debt is questionable, and the banks are now in a stronger position to handle write downs, shouldn't the regulators more aggressively pursue the creation of ATRRs?

A.3. Section 905(a)(1) of the International Lending Supervision Act authorized the banking agencies to require a banking institution to establish and maintain a special reserve whenever in the judgment of the agencies:

> (A) the quality of such banking institutions' assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors, among others, as-
>
> > (i) a failure by such public or private borrowers to make full interest payments on external indebtedness;
> > (ii) a failure to comply with the terms of any restructured indebtedness: or
> > (iii) a failure by the foreign country to comply with any International Monetary Fund or other suitable adjustment program; or
>
> (B) no definite prospects exist for the orderly restoration of debt service.

Although many countries have had difficulties in meeting their external indebtedness, only seven countries at this time have experienced difficulties severe enough to meet the definition of Value Impaired, which mirrors the language of Section 905(a)(1). The assignment of a Value

Impaired rating is a serious criticism of a country's credit standing, the effect of which is to limit a country's ability to raise funds. A rating of Value Impaired could cause difficulties for a nation trying to work with its creditors. If the creditors were U.S. banks, they would be required to establish specific reserves or take charge-offs and would be less inclined to advance new funds.

The bank supervisors must balance the need to accurately assess the quality of the bank's assets with the impact a rating might have on a borrowing country's ability to solve its economic problems. A premature rating of Value Impaired would be harmful to both the country and its creditors and would not contribute to the ultimate resolution of the debtor country's financial difficulties. Consequently, in drafting the definition of Value Impaired, the intention was to limit it to those situations where problems were protracted and the borrower was not complying with any agreement to solve the problem or definite prospects for restoration of debt service did not exist.

Q. 4. From our discussion at the hearing, it is clear that there is a growing recognition that some LDC debt is not worth its full face value. A secondary market is trading the debt of a variety of countries at a discount; some banks are writing-down LDC debt; and you the regulators are mandating reserves for selected countries. Yet even where debt is being written down, little of the benefit of reduced debt service is received by the LDCs.

Why shouldn't regulators be taking a more accommodative stance toward debt settlements arranged between the bank and LDC creditors involving modification of terms on troubled debt and/or acceptance of assets in lieu of cash (equity, securities, goods, real estate, etc.)? What are the benefits or problems of applying the guidelines of FASB 15 and general regulatory forebearance to the LDC debt problem?

A.4. At the June 25th hearing, one witness testified that there was growing recognition that some LDC debt was not worth its face value, that some LDC debt was trading at a discount and that the banks were writing-down LDC debt. In commenting on this statement, it should be noted that while some debt has been written down or sold at a discount (reportedly, the amounts sold have been insignificant), such write-offs or sales will not necessarily lessen the debt servicing burden of the borrower. The size of the obligation remains the same. An exception would be those instances where the borrowing country itself has been able to purchase the debt at a discount. Lending institutions that have taken chargeoffs, however, may have concluded that while full repayment seems remote, they are not willing to surrender their claim to full repayment.

Although a nation may benefit from debt relief granted by lenders or from discount purchases of their debt, this does not, in itself, restore a nation's creditworthiness. Without economic and structural reforms, the benefit from debt relief may be short-lived since the country's basic problems will remain unresolved and lenders and other investors may not be willing to repeat past mistakes.

The role of the bank supervisors in accommodating settlements between lending banks and borrowers is limited to ensuring proper and timely loss recognition, where applicable. In recognizing the existence and size of losses, the supervisors are guided by FASB 15. FASB 15 states that as long as the restructuring involves only a modification of terms on an existing debt owed by the borrower, and as long as future cash receipts (which include principal and interest) under the modified terms are at the least equal to the recorded amount of the loan (plus any accrued interest) before the restructuring, no immediate loss recognition is necessary.

On the other hand, if the existing debt owed by the borrower is extinguished in exchange for cash or the acceptance of other assets, such as equity securities, real estate, or third party receivables, the fair value of the assets received must be established. The fair value must then be compared to the recorded balance of the loan immediately before the restructuring to determine the amount of any loss recognition at the time of restructuring. Any excess of recorded amount over fair value would result in the immediate recognition of a loss for the amount of this deficiency under FASB 15.

Estimates of future cash flows and the fair value of assets will determine the impact of FASB 15. For example, a troubled debt restructuring that involves only a modification of terms to an existing borrower, such as a lowering of the interest rate, may have little or no immediate impact on a bank's income statement provided the recorded cash flows are at least equal to the recorded amount of the loan. In contrast, a full satisfaction of the borrower's debt in exchange for the receipt of assets from the borrower is a restructuring that may subject a bank to immediate recognition of loss, if the fair value of the assets received is less than the recorded amount of the loan.

Q. 5. A number of innovative approaches toward international lending which provide debt relief to LDC borrowers are being developed:

- debt-equity swaps
- conversion of debt into long term securities
- interest payments in local currency, with possible later conversion to foreign exchange.

How should these specific approaches be handled by regulators and accountants? Are banks scared away from these innovations by regulatory treatment, or is the current regulatory framework supportive of institutions passing along debt relief to the countries? What are the legal, accounting impediments?

A.5. Debt-Equity Swaps. A swap of existing debt in return for an equity interest is not a modification of terms under FASB 15. Rather, the debt obligation is viewed as being fully or partially satisfied in exchange for the bank's receipt of an ownership interest. Under such a debt for equity swap, FASB 15 requires the property received (i.e., the equity interest) to be booked at its fair value. This value is compared to the recorded amount of the loan immediately before the restructuring for purposes of determining the amount of any immediate loss that should be recognized if the property is received in full satisfaction of the debt or the amount of the reduction of the loan amount if the property is received in partial satisfaction of the debt.

Conversion of Debt Into Long-Term Securities. Under the provisions of FASB 15, a restructuring of existing short-term debt for longer term debt securities would be viewed as a modification of terms on an existing debt. If the reasonably expected cash receipts under the restructured debt terms are at least equal to the recorded amount of the loan before restructuring, no immediate loss recognition is required. An exception may arise, however, when there is a substitution of debtors in conjunction with the debt swap. In such cases, the fair value of the third party receivable acquired by the bank must be compared to the recorded amount of the loan to the original borrower for the purpose of determining the extent of any immediate loss recognition.

Interest Payments in Local Currency with Possible Later Conversion to U.S. Dollar Exchange. A bank might restructure its lending arrangement to allow a foreign debtor to make interest payments in the local currency by depositing them with a designated intermediary (e.g., the foreign central bank) for the account of the lender. This intermediary would agree to convert the local currency into U.S. dollars at some future date at an exchange rate that will protect the bank from exchange rate risk. In this situation, the regulatory view has been that no loss recognition would be required at the time of the repayment arrangement. The foreign debtor would be able to service his debt without being concerned about exchange rates and the availability of U.S. dollars. The bank would be able to treat the foreign debtor's loan as performing and would also have a claim on the intermediary at an agreed upon exchange rate for the payments made by the debtor. The bank would, however, have to evaluate the collectibility of the claim on the intermediary on an ongoing basis and might need to recognize a loss under FASB 5 (Accounting for Contingencies) or set up an ATRR at the direction of the regulatory agencies.

We can think of no circumstances where regulatory treatment differs substantially from the accounting treatment discussed above.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM CHARLES COLLIER

Q. 1. As it stands now, banks are able to address the problem of lower-quality assets, concentrated in Latin American countries, through the allocated transfer risk reserve.

Could that approach be expanded? Should it?

Does the quality of the loans owed to U.S. banks warrant an expansion of the allocated transfer risk reserve?

A. 1. This question was addressed in the answer to question number three of Senator Heinz.

Q. 2. I understand that European banks are characterizing this debt problem as a U.S. bank problem.

How have they arrived at that conclusion?

What impact is their policy of writing down L.D.C. loans having on U.S. banks?

A. 2. The difficulties facing the troubled LDC countries are worldwide problems. The American banks, corporations, and government agencies, while holding a large portion of the LDC's debt, do not hold a majority of it. Other nations such as Japan, also have large portions of the debt, as do banks in Europe. Also, while the United States has enjoyed a large volume of trade with the LDC's, other nations have had a large volume of trade with LDC's as well. The inability of LDC borrowers to make timely loan repayments and the contraction in trade and services between the LDC's and the industrial world has been deleterious to all trading partners and is not limited to a creditor nation or trading partner sharing a common border or in the same hemisphere.

Q. 3. In the Joint Economic Committee on June 24th, a witness quoted Helmut Schmitt as saying he felt that Latin American debts are largely uncollectible. Do you agree with that conclusion?

To the degree that they are, at least in part, collectible, what is preventing the banks from reducing the threat unilaterally, from participating in the Baker Plan?

To the degree that loans are not collectible, what is preventing the banks from recognizing that fact in the computation of the quality of their assets?

A.3. After consultation with Senator Sasser's aide, the question was rephrased as follows:

1) Do you believe that the Latin American debts are largely uncollectible?

We believe that most Latin American debts are serviceable and eventually collectible. It should be noted that it is not necessarily optimal that Latin American external debts be repaid over the next decade or two. Such a repayment would require an untimely transfer of resources that was never intended. What is optimal is for all countries to be creditworthy; to be able to service their existing debts; to utilize productively new inflows of funds; and for their existing debts to be attractive enough to enable ready transfers to other would be lenders; in short, for their debts to be considered bankable assets.

Some loans to a few Latin American nations do appear to be uncollectible, and that debt has been categorized as Value Impaired. Required reserves or charge-offs have been made by the lending banks. For other countries, the debt problem is serious but less severe. These other countries have successfully renegotiated the terms of the debt and/or undertaken basic reforms that will allow servicing of their debts. While these loans contain elements of risk, such risks are being recognized through increases in the allowance for loan losses. At this time, specific reserves or loss recognition on these other loans appears premature.

2) What is preventing the banks from participating in the Baker Plan?

The Baker Plan contains three elements. Increased lending by the commercial banks is the third and last element. The first two elements require adoption of comprehensive macroeconomic and structural policies to promote growth and reduce inflation, and mandate a central role for the IMF and other multilateral development banks in support of market-oriented policies for growth. These elements are evolutionary in nature and are not intended to produce short-term solutions and concurrent new lending. Many countries have not evolved through the first two elements. Moreover, some Baker Plan countries have not needed new funds since the announcement of the plan last October and the banks have not been requested to provide additional monies. Consequently, in our view, it is too early to judge the role of banks in the Baker Plan, although we remain optimistic. Participation in the program would be the best chance for the countries involved to generate the growth that would allow for the restoration of debt service and acquisition of additional funds.

3) What is preventing banks from recognizing uncollectible loans in their computation of asset quality?

As mentioned earlier, banks have been charging off or establishing reserves where loans to LDC borrowers have been judged uncollectible. Banks have also been increasing their general allowance for loan losses in recognition of the fact that loans to other borrowers, including those in Latin America, may become uncollectible.

Q. 4. How would you characterize the distinction between the implication of "writing off" a loan and "reserving against" a loan?

What role does any distinction have in resolving the problems associated with Latin American debt?

A.4. Generally Accepted Accounting Principles (GAAP) distinguish between a write-off and reserving in that a write-off cannot be recovered until payments are received and principal remaining on the books has been repaid. A reserve may be reversed once ability to repay has been demonstrated.

Banks may not be willing to advance new funds to a country until any amounts written off have been repaid. Such distinction could impact a country's adjustment process if banks are unwilling to lend new money.

Q. 5. Please respond to the estimate that in the next 10 years, one-third of the regional Latin American debt of $380 billion will have to be written off.

A.5. As mentioned earlier, banks have taken mandated charge-offs or established reserves for Value Impaired debt where the particular country's ability to repay its external obligations appears remote. The supervisory agencies have not identified other loans where the possibility of loss is imminent. While additional losses may occur, a figure of one-third of regional Latin American debt appears high.

Q. 6. According to many estimates, for a free economy to survive, its debt-to-gross domestic product ratio cannot be higher than 25 percent. In the case of Mexico, with a $100 billion debt and a gross domestic product of $175 billion, the ratio is 60 percent. Chile's is at 120 percent. Brazil at 40 to 45 percent. Argentina at 70 percent.

In view of these ratios, the comment was made in testimony yesterday that it is, quote, "the utmost folly," unquote, to be increasing the debt. How would you respond to that?

Does increasing debtor nations' debt actually contribute to their credit-worthiness?

A.6. A country's debt-to-gross domestic product (GDP) is an important ratio in assessing its overall creditworthiness; however, it is by no means the only tool that should be used in evaluating a country's ability to service its debt. Neither is it accurate to say that this ratio can be no higher than 25% in order for a free economy to survive. Several Western European countries exceed this ratio: notably Belgium, Denmark, Finland, Ireland, Norway, Portugal, Sweden and Switzerland.

Other ratios such as debt-to-exports and debt service as a percentage of exports are probably equally as important, if not more so, than debt-to-GDP in rating a country's ability to service its external debt. Some economies are more export-oriented than others and are thus able to more easily generate the foreign exchange necessary to service their external debt. For example, Korea's debt-to-GDP is at 55% where Brazil's

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is 49%. However, Korea's debt-to-exports is 130%, but the comparable ratio in Brazil is 337%. Korea has experienced no difficulty is servicing its external debt while Brazil has been forced to negotiate several restructurings over the past few years.

To say that it is "the utmost folly" to be increasing the debt is not a fair statement. To the extent that the new debt is being used, either directly or indirectly, to build on a country's infrastructure and/or enhance its export capabilities, the net result is an improvement in the country's creditworthiness.

As stated previously, banks will usually only agree to advance additional funds if the country has agreed to a suitable economic adjustment program. Compliance with such a program is periodically monitored, usually by the IMF. When banks agree to advance new money, it is not done as a lump-sum advance. Rather, the money is advanced in tranches at agreed-upon intervals. Each tranche is subject to a satisfactory review of the country's performance under its economic adjustment program. This is a further precaution taken by the banks to ensure that new money is not being advanced unless the country is taking the steps necessary to improve its creditworthiness.

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Q. 7. What kind of innovations have you seen among debtor nations for stemming capital flight? I'm interested in your assessment of, for example, debt-equity swaps, financial investment structures, and other initiatives designed to reduce debtors' need for new loans What recommendation have you made, and what would you like to see done?

A.7. A number of means of stemming capital flight have been employed, not all of which can be categorized as innovations. Mexico severely tightened credit availability in the country, forcing businesses to repatriate capital as the only means of financing operations. Other countries have tightened control mechanisms on trade practices to prevent over- and under-invoicing. We have observed that when a capital flight problem exists, it is because the citizens have lost confidence in a country's economy; the country's exchange rate is either too high; or local economic and political conditions are not favorable for private investment or saving. Hence, any measures that a country undertakes to address these conditions would act to reduce capital flight.

The FDIC has had little direct opportunity to assess debt-equity swaps and other financial arrangements, such as debt sales, to reduce or transfer a country's external debt. We doubt that debt-equity swaps and loan sales will make a significant contribution to resolving a country's debt problem. To the degree these arrangements permit some creditors to restructure or reduce their exposure or facilitate equity investments, they can be helpful to both lender and borrower.

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We think, however, that the benefits to the borrowers can be overestimated. While it is true that a secondary market can benefit all participants in a market, from what we have observed, many of the parties liquidating their exposure through asset swaps or loan sales, at sizable discounts, are permanently withdrawing from lending to the particular country or the LDC's as a group. Moreover, countries whose debt is being swapped must consider the monetary impact from the extra liquidity. As a result, we are informed, some nations have placed limits on the amount of swaps they will permit. Also, discounted loan sales reflect negatively on the country's credit reputation and will be a hindrance in the future when the country seeks new borrowings. No country anticipating near-term borrowings in the external markets benefits by a discounted sale of its debt.

Q. 8. Testimony was received in the Joint Economic Committee this week to the effect that the definition of the problem is wrong, that we need to get the debt problem "off center stage" and focus on restructuring ... not short-term liquidity. Do you agree that short-term liquidity is a misplaced focus of this debate? How do you go about restructuring without harming U.S. manufacturing and agriculture?

A.8. Distinction between illiquidity and insolvency is more complicated when dealing with sovereign, as opposed to corporate or individual, borrowers. In the business world, an insolvent creditor obtains debt relief at a severe price. Even if the debtor survives, assets can be sold, management replaced, and the business harshly pruned. Only then might it be attractive to new lenders. Insolvency, in the business sense, implies permanency of relief; bankruptcy courts grant debtors permanent and enforceable relief from creditors. Unlike dissolved corporations, countries do not disappear; they may repudiate their debt, claim sovereign immunity, or their financial affairs may deteriorate to such a point as to render the collectibility of their debts remote. Foreign creditors however, may still be able to seize borrowers' assets if located outside borrowers' territories. Moreover, lenders and other investors may refuse to extend new loans or make new investments in the countries if they believe they were treated unjustly by the borrower.

Deterioration or insolvency in a country's financial condition, where there are no prospects for orderly debt restoration, similar to conditions present in a corporate bankruptcy, is recognized by bank supervisors in the Value Impaired classification. The majority of LDC debtors, while experiencing problems, have not deteriorated to such a state and are more appropriately viewed as having liquidity problems.

While LDC debt restructurings may negatively impact U.S. manufacturing and agriculture in the short run, over the longer term, the results of debt restructurings should prove beneficial to U.S. interests. The LDCs' economies will be strengthened which should result in an expansion of the LDC market for U.S. exports.

Q. 9. What is the effect on bank stock prices of acknowledging that the quality of some of the assets associated with lending to these debtor nations has fallen to below par value?

Haven't there been recent instances where the prices have actually risen in response to a bank's public recognition of reality?

A.9. Stock prices of most large banks have risen in recent years. not only in response to individual institutional events, but also due to a number of general industry trends. Strong earnings performance, despite large loan loss provisions and hefty charge-offs, have offset asset quality concerns to some extent. The recognition of existing and possible portfolio problems (including the LDC portfolio) in the form of increased loan loss reserves has also helped offset investor concern over loan quality, as it has served to reduce the impact of losses and nonperforming assets (including LDC's) on future earnings. Also, a positive factor has been the reduction in the proportion of LDC debt both to total assets and primary capital. Another positive factor is the diversification of banks' operations and earnings, particularly into fee-related businesses and profitable specialized areas such as nationwide consumer banking services.

Investors have responded favorably to better earnings, increased allowances for losses and primary capital, diversification of earnings, and a recent favorable interest rate environment. As a result, the stock of five of the nine money center bank holding companies is selling at or above book value. While this is a considerable improvement from 1982, when the stock of only two of these institutions was selling at or above book value, the price-earnings ratios for the large bank holding companies are considerably below the average price-earnings ratio for most publicly traded companies. This reflects, we believe, investors' lingering concern over the asset quality of these large institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM CARLETON R. HASWELL

Q1. Several innovative approaches toward international lending are being developed, such as debt-equity swaps, conversion of debt into long-term securities, a secondary market for old debt, and so forth.

Have you used any of these mechanics? What approaches have you taken aside from standard loan reschedulings? Is current regulatory treatment of such mechanisms a major disincentive, especially for large banks worried about valuation of their overall portfolio?

A1. Activities such as those mentioned have varying degrees of merit, but do not constitute a solution to the debt problem. The ultimate solution to debt problem is economic growth.

For that reason, debt equity swaps may be helpful, not because they will significantly decrease either the total debt or the servicing of that debt, but because they may stimulate capital investment, job creation and economic growth in the recipient country. For obvious reasons, debt equity swaps are generally confined to the private sector.

Conversion of debt into long term securities, although possibly having some of the merit of a debt-equity swap, is basically no more than a differently documented restructuring of loans.

A secondary market for debt does exist, but such market is primarily confined to private sector obligations. Much of this activity originates with principals of the obligor attempting to purchase obligations of their company at a value below par.

We are actively studying opportunities available in connection with debt equity swaps, but are not active in the latter two areas. Significant contributing factors are clearly the uncertainties as to regulatory and accounting treatment, as well as the uncertainties attending the future tax treatment of loan loss reserves.

Q2. The issue of capital adequacy for banks with substantial LDC exposure was raised at the hearing. U.S. banks have now accumulated $105B of total capital, but it is not clear that those with heavy LDC exposure are better capitalized. Imposition of special reserves (ATRRs) by regulators has been very limited. Only $2.4B of ATRRs have been established against the $90B of LDC debt held by U.S. banks that is rated as troubled (in the OTRP category or below.) The above numbers argue for stronger reserve positions and higher capital requirements for banks with heavy exposure to troubled LDC debtors than for other banks.

Have you set aside substantial reserves for LDC debt outside of the special reserves required by regulators? Do you hold back in reserving where you believe regulators may impose ATRRs?

A2. We do not make specific allocations in the determination of our loan loss reserve. The loan loss reserve represents the amount that in management's judgment is adequate to absorb future, but presently unidentifiable, losses in the loan portfolio. This judgment reflects a number of factors, including the composition of the portfolio. At Chemical New York Corporation the loan loss reserve as of December 31, 1982, amounted to $318 million, or 1.03% of total loans. As of June 30, 1986 the reserve was $607 million, or 1.55% of total loans. The large increase in the reserve reflects in part the uncertainties surrounding LDC debt. For the ten largest bank holding companies the aggregate loan loss reserves at year end 1982 amounted to $4 billion or 0.93% of the total loans in those institutions. As of June 30, 1986, the aggregate loan loss reserves amounted to $9.2 billion or 1.77%.

We believe that expanded use of ATRRs is appropriate only on the basis of a clear-cut inability for a country to remain current on its debt obligations.

Q3. Some have suggested that the only way to resolve the LDC debt problem is for banks to grant a certain degree of debt forgiveness to develop some procedure similar to our bankruptcy statutes. However, the Baker Initiative calls for new lending and Chairman Volcker recently voiced strong opposition to debt forgiveness of any kind, claiming that only a few countries in "deepest Africa" are currently unable to meet their debt service obligations.

Four years into the debt problem, do you believe all but a few LDC borrowers can and will service their loans in a timely fashion? If there are likely to be continuing problems, why do the banks not reorganize the debt as with a failed domestic corporation? Are banks reluctant to take this approach because of their focus, and the market's focus, on current earnings as the almost exclusive measure of their health? How would the market view a one-time accurate revaluation of a bank's LDC portfolio?

A3. We believe that all but a few borrowers can and will service their debt, but some will require further assistance with the maturity schedule of principal payments.

In cases of continuing problems, solutions will be found. Consentual and judicial reorganizations of a troubled domestic corporation are vastly different from that of a sovereign state from legal, economic, political and social points of view. Failure to reorganize a sovereign state's debt is unrelated to current earnings of banks. Corporate reorganizations generally result in an exchange of debt for a combination of immediate cash, debt and equity securities and are predicated on the assumption that the reorganized entity will be financially viable. Neither such result or assumptions is true in the case of sovereign debt. Sovereign debt reductions will not result in business as usual. As to the market's reaction to "a one-time accurate revaluation of a bank's LDC portfolio", we believe that our current valuation is correct. We would, however, adjust that valuation in the future should conditions dictate.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM CARLETON R. HASWELL

Q1. When Secretary of Commerce Baldrige testified before the Banking Committee on May 14, he said if a commercial bank has a problem loan, and would like to write it off at 10 percent a year for 10 years, it would not be allowed to do so by the bank regulators. He said once a bank admits a loan is not good it has to write off 100 percent of it at once or else immediately set up a debt reserve equal to the size of the loan.

Is that accurate? What do you think of Secretary Baldrige's proposal? What are pros and cons of such a proposal for bank safety and soundness? Are there ways for our banks to write off these LDC loans over a period of years?

A1. The understanding of accounting for bad loans attributed to Secretary Baldrige is generally accurate. Furthermore, this treatment is required not only by regulators but also by accounting standards. Whatever portion of a loan is deemed uncollectible is written off when such determination is made. If the amount deemed uncollectible is less than 100% of the loan, only that portion is written off. In practice, it is not unusual that a borrower's circumstances change over time and opinions are revised. This results in additional loan amounts being charged off if ultimate collectibility is deemed less, but rarely in restoring of loan values if ultimate collectibility is deemed greater; in the latter case, recoveries are recognized through payments. This can result in a loan being written off over a period of time - but, as a result of deterioration circumstances and not as a matter of accounting convention.

It should be pointed out that even if regulators were to allow for recognition of write-offs over a period of time, accounting standards would require banks to recognize such write-offs in full for purposes of their financial reports and accounts.

To write off loans deemed to be uncollectible in periods subsequent to the one in which such determination is made would misrepresent both the earnings of those future periods and the financial position while such "catch up" was taking place. It would also strain the credibility of the financial reporting mechanisms.

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It should be noted that the only time any charge-off can be proven correct is when all legal remedies have been exhausted and the borrower legally liquidated or when the borrower and lender agree in writing to a settlement of debts.

Q2. You testified on June 25 that your bank, the Chemical Bank, has written off some of its exposure to some LDC countries that are having severe problems. Can you for the record provide a list of the countries where Chemical Bank has written off some of its exposure and the amount of exposure written off in each? Can you also provide the amount of Chemicals remaining exposure in each such country? Can you also tell us what it means to write off your exposure. Does your bank still maintain a claim against such countries for the amount "written off" or does a write off mean debt is forgiven?

A2. When we write off any loan we incur a loss which reduces the reserve for loan losses. For at least the last decade, this has also meant a reduction in earnings in the period the charge-off is taken as we have replenished the reserve by an amount greater than the amounts charged-off in each period. The bank maintains a claim against the countries after a write-off and has not yet forgiven any debt of a country. We are also very disturbed that the regulators ATRR requirement has been ascertained by the media and published. This hinders our efforts in dealing with borrowers since they know that we have been required to take a charge-off. In addition, disclosure is a violation of either law or statute as this information is to be held confidential by each bank and its regulator and to our knowledge no one has been prosecuted as proscribed in such law or regulation. Since we maintain a claim against a country even after a write-off, we would not wish to disclose either the name of any country or the amount of any given write-off. Further, such information could well be of value to our domestic and foreign competition.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM CARLETON R. HASWELL

Q1. As it stands now, banks are able to address the problem of lower-quality assets, concentrated in Latin American countries, through the allocated transfer risk reserve.

Could that approach be expanded? Should it?

Does the quality of the loans owed to U.S. banks warrant an expansion of the allocated transfer risk reserve?

A1. The Allocated Transfer Risk Reserve is useful to the regulatory authorities to the degree that it provides conformity in the treatment of assets that are deemed to be of low quality. Thus far, we feel that the approach has been prudently administered.

Our judgment is that the quality of loans owed to U.S. banks does not - at this time - warrant an expansion of this reserve.

Q2. I understand that European banks are characterizing this debt problem as U.S. bank problem.

How have they arrived at that conclusion?

What impact is their policy of writing down LDC loans having on U.S. banks?

A2. Although some non-U.S. bankers may characterize the debt problem as a U.S. problem due to geographic proximity, trade flows and national security interests, the fact is that approximately 65% of Latin American debt to banks is owed to non U.S. banks and only 35% to U.S. commercial banks.

Although other banking systems may have more attractive tax treatment and are therefore more aggressive in creating reserves, we believe that commercial banking systemic behavior will be consistent with ours in seeking the payment of the debt in its entirety.

Q3. In the Joint Economic Committee on June 24th, a witness quoted Helmut Schmitt as saying he felt that Latin American debts are largely uncollectible.

Do you agree with that conclusion?

SASSER--HASWELL

To the degree that they are, at least in part, collectible, what is preventing the banks from reducing the threat unilaterally, from participating in the Baker Plan?

To the degree that loans are not collectible, what is preventing the banks from recognizing the fact in the computation of the quality of their assets?

A3. We believe that the debts of Latin America are collectible. It will take time, cooperation and growth in both the LDCs and the industrialized world. We also believe that the amount of debt will not decline but will become more manageable and be available in the voluntary credit markets, thereby allowing each bank to reach individual conclusions and have the choice of entry or exit.

Q4. How would you characterize the distinction between the implications of "writing off" a loan and "reserving against" a loan?

What role does distinction have in resolving the problems associated with Latin American debt?

A4. A loan is written off when it is deemed uncollectible. "Reserving against a loan" is an imprecise and confusing phrase. The allowance or "reserve" for loan losses is maintained (by charges to income) at a level that, in management's judgment, is adequate to absorb future losses inherent but unidentifiable in the loan portfolio. Management's judgment is based on an evaluation of individual credits; the size and diversity of the portfolio, particularly in terms of industry and geography; and past loan loss experience in various portfolio segments. Current and potential economic and political conditions are also taken into account.

The distinction then between "writing off" a loan and "reserving against" a loan would involve specificity - you "write off" a specific loan and you "reserve against" an entire portfolio. When a loan, or portion thereof, is determined to be uncollectible, it is written off in the amount so determined. Up until that point, its collectibility would be one of many factors entering into the determination of that amount of the reserve for loan losses.

SASSER--HASWELL

Until such time as a specific Latin American debt is deemed uncollectible, the reserve for loan losses should reflect, among other things, any uncertainty felt by management as to Latin American debt.

As long as the reserve for loan losses adequately reflects the judgment as to the potential future losses, we feel that the imposition of a policy requiring higher charge-offs than determined by current standards could complicate the resolution of Latin American debt problems by decreasing the overall likelihood of recovery.

Q5. Please respond to the estimate that in the next 10 years, one-third of the regional Latin American Debt of $380 billion will have to be written off.

A5. We expect that Latin American countries will continue to be able to maintain debt service payments on most of their outstanding debt. Undoubtedly, there will have to be further extensions of maturities and other restructurings. But we do not expect actual write-offs of debt to be anything like the magnitude suggested in the questions.

Estimates of sizeable write-offs arise mostly from mechanical extrapolations of existing debt/GDP or debt service/export ratios compared with some predetermined notion of an "acceptable level" of such ratios. We fully agree that these ratios are presently too high in most Latin American countries. But we also believe that they can and will be reduced to more manageable levels by a combination of further debt restructuring, more export-oriented policies in the debtor countries, and sustained growth in the world economy. This is a much more appropriate solution than a one-time write-off of debt.

Q6. According to many estimates, for a free economy to survive, its debt-to-gross domestic product ratio cannot be higher than 25 percent. In the case of Mexico, with a $100 billion debt and a gross domestic product of $175 billion, the ratio is 60 percent. Chile's is at 120 percent, Brazil at 40 to 45 percent. Argentina at 70 percent.

In view of these ratios, the comment was made in testimony yesterday that it is, quote, "the utmost folly," unquote, to be increasing the debt.

How would you respond to that?

Does increasing debtor nations' debt actually contribute to their credit-worthiness?

A6. As indicated in our answer to the preceding question, we agree that debt/GDP ratios are presently too high in many Latin American countries. But that is no reason for these countries to abstain completely from further borrowing. Indeed, in most cases, continuing economic development requires an on-going inflow of capital to these countries, much of which will inevitably have to come in the form of international borrowing.

The key is to control the pace of further debt accumulation to a rate that can be managed. An overly simplified, but somewhat useful criterion is that growth of debt should be held sufficiently below the growth of a country's exports so that the ratio of its debt service payments to exports will be reduced toward more appropriate levels over a 5-10 year time period. Export promotion policies and other restructuring of the domestic economy to encourage internal savings are clearly of key importance in this process. As the appropriate economic policies are implemented, we do believe that controlled growth of debt does contribute to a restoration of a nation's credit-worthiness.

Q7. What kind of innovations have you seen among debtor nations for stemming capital flight?

I'm interested in your assessment of, for example, debt-equity swaps, financial investment structures, and other initiatives designed to reduce debtors' need for new loans.

What recommendations have you made, and what would you like to see done?

A7. The financial "innovations" cited in the question are among various alternatives that have been devised for dealing with the existing debt of major borrowing countries. They do not address the problems of on-going capital flight from many of these countries.

In our view, the only effective way to stem capital flight is for the countries involved to look at the fundamentals of their domestic economic policy and the resulting attractiveness of investment opportunities within their economy. In essence, this is what "conditionality" and the "Baker Initiative" have attempted to articulate. Brazil and various Southeast Asian countries are clear examples of the successful management of capital flows through adoption and maintenance of appropriate domestic policies and a restructuring of the domestic economy toward more reliance on the private sector, adequate encouragement of private investments, and an orientation toward increasing exports.

Q8. Testimony was received in the Joint Economic Committee this week to the effect that the definition of the problem is wrong, that we need to get the debt problem "off center stage" and focus on restructuring ... not short-term liquidity.

Do you agree that short-term liquidity is a misplaced focus of this debate?

How do you go about restructuring without harming U.S. manufacturing and agriculture?

A8. We agree that a restructuring of Latin American economies, i.e., privatization of state owned enterprises, reduction of subsidies, breaking down tariff walls and other protectionist measures, is necessary for a successful resolution of the debt problem. In our opinion, these actions would lead to increased investment, both indigenous and external, increased productivity and economic growth.

One of the most positive aspects of a policy such as this is the opportunity it would create for U.S. manufacturing and agriculture, rather than the status quo which is very negative for those sectors.

Q9. What is the effect of bank stock prices of acknowledging that the quality of some of the assets associated with lending to those debtor nations has fallen to below par value? Haven't there been recent instances where the prices have actually risen in response to a bank's public recognition of reality?

A9. The very existence of a loan loss reserve indicates that, in aggregate, the value of a bank's loan portfolio is considered by the bank's management to be less than par.

SASSER--HASWELL

We are not aware of any examples of banks experiencing an increase in their stock price following an announcement of major write-offs. The question implicitly draws a comparison to the case of an industrial company's write-off of an ailing subsidiary, plant or equipment. There are many examples of announcement of such write-offs, by industrial companies triggering a rise in the company's stock price. We doubt that there would be a similar reaction if banks were to announce the write-off of a portion of their LDC portfolio. In the case of an industrial company investors respond favorably because the write-off represents certainty in the elimination of the negative results stemming from the ailing activity. By contrast when banks write-off a portion of a loan portfolio investors have little ability to predict whether there will be further write-offs associated with that portfolio. Thus in the case of banks the write-off does not eliminate the uncertainty, and it is uncertainty that deters investors and holds down stock values.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM CHARLES M. HAMMEL

Several innovative approaches toward international lending are being developed, such as debt-equity swaps, conversion of debt into long-term securities, a secondary market for old debt, and so forth.

Have you used any of these mechanisms? What approaches have you taken aside from standard loan reschedulings? Is current regulatory treatment of such mechanisms a major disincentive, especially for large banks worried about valuation of their overall portfolio?

Answer 1.

AmeriTrust Company has on occasion sold pieces of LDC debt when either a small loss as a result of the sale or, in fact, a gain on the sale was made possible through prior application of interest payments to the principal balance over a number of months. On value impaired credits, we have also considered and will continue to consider debt-equity swaps. At the moment, the current regulatory treatment of such mechanisms is not particularly a disincentive assuming, and it is a very important assumption, that the prior treatment of the debt had been prudent by the bank, such as the application of interest payments to principal.

Q2. The issue of capital adequacy for banks with substantial LDC exposure was raised at the hearing. U.S. banks have now accumulated $105B of total capital, but it is not clear that those with heavy LDC exposure are better capitalized. Imposition of special reserves (ATRRs) by regulators has been very limited. Only $2.4B of ATRRs have been established against the $90B of LDC debt held by U.S. banks that is rated as troubled (in the OTRP category or below.) The above numbers argue for stronger reserve positions and higher capital requirements for banks with heavy exposure to troubled LDC debtors than for other banks.

Have you set aside substantial reserves for LDC debt outside of the special reserves required by regulators? Do you believe expanded use of ATRRs is appropriate? Do you hold back in reserving where you believe regulators may impose ATRRs?

Answer 2.

Since the onset of the debt crisis in August of 1982, AmeriTrust, as a prudent lender, has continuously evaluated the special reserves required to cover LDC exposure. At the present time, our international loan portfolio is approximately 10.07% reserved which is high by industry standards. We feel, however, that this high reserve figure continues to be a wise one. The expanded use of ATRRs is probably most appropriate when there has been a breakdown in restructuring negotiations between a country and all its lenders, including the IMF and the World Bank. As a bank, we do not "hold back in reserving" when we believe the regulators may impose ATRRs.

2 HEINZ--HAMMEL

Q3. Some have suggested that the only way to resolve the LDC debt problem is for banks to grant a certain degree of debt forgiveness to develop some procedure similar to our bankruptcy statutes. In your testimony, you indicated growing interest among regional banks in interest rate concessions. Yet the Baker Initiative deals only with new lending and Chairman Volcker has voiced strong opposition to debt forgiveness of any kind, claiming that only a few countries in "deepest Africa" are currently unable to meet their debt service obligations.

Do you see the possibility of significant bank reorganization of LDC debt as with a failed domestic corporation? Are banks reluctant to take this approach because of their focus, and the market's focus, on current earnings as the almost exclusive measure of their health? Are the smaller banks interested in more drastic measures simply because of their smaller exposure?

Answer 3.

In my earlier testimony on June 25, 1986, I indicated that some banks may prefer to deal with LDC exposure by reducing interest rates rather than extending additional credit in the form of new money facilities. The parallel to failed domestic corporations could be made, however, my remarks were more in the context of "saving" a country as much money by reducing the interest rates as it might gain from new money (and hence higher exposure) contributions. I also mentioned in my previous testimony that banks needed to be more creative - in the constructive sense of the word - by finding alternatives equally viable to new money. The alternatives must be viable both for the debtor nations as well as for the banks themselves. Certainly, as your questions imply, market focus and current earnings may make it difficult for some banks to consider interest rate concessions. That should not rule them out for those banks which wish to take that approach.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM CHARLES M. HAMMEL

Q-1: On page 2 of your prepared testimony you noted that different banks may have different ideas on how to aid the ultimate recovery of the most indebted nations. "Many banks," you said, "might prefer to drastically lower interest rates rather than to contribute new loan funds. Other banks, whose earnings would be severely impacted by drastically reduced interest rates may prefer to extend further credit".

If your bank wanted to drastically reduce interest rates, or even write off the value of LDC loans on your books are there any legal impediments to your doing so? If a bank chose such a strategy would it face any criticism from the larger banks or the bank regulators? Have the money center banks and or the regulators put any pressure on the smaller banks to continue lending to the Latin debtor countries or to refrain from writing down or reducing interest rates on such loans?

Answer 1.

I am not a lawyer, but there would appear to be few legal implications to drastically reducing rates or even writing off the value of LDC loans. However, there might be considerable tax implications of doing so. As far as the larger money center banks are concerned, if regional banks began to take the approach on a widespread basis, the money center banks could argue that the short term liquidity needs of the country involved are not being met as much through reduced interest servicing costs as through the infusion of new working capital. The regulators' reaction would best be posed to them, but a case could be made that the action reflects prudent credit policy. To date, as far as we are concerned, no such pressure from money center banks has been received, but the concept has not been formalized or tested.

Q-2: When Secretary of Commerce Baldrige testified before the Banking Committee on May 14 he said if a commercial bank has a problem loan, and would like to write it off at 10 percent a year for 10 years, it would not be allowed to do so by the bank regulators. He said once a bank admits a loan is not good it has to write off 100 percent of it at once or else immediately set up a debt reserve equal to the size of the loan.

Is that accurate? What do you think of Secretary Baldrige's proposal? What are the pros and cons of such a proposal for bank safety and soundness? Are there ways for our banks to write off these LDC loans over a period of years?

Answer 2.

Generally speaking, if there is no prospect of debt service of any type - principal or interest payments - it is difficult to justify only a partial writedown of a credit. Any solution of the type proposed by Secretary Baldrige would have to be done in conjunction and cooperation with all the regulatory agencies including the SEC and the banks. As pointed out in response to Senator Sasser's question, such an approach might make the ultimate collectability of the debt by the banks difficult since the borrower knows that the banks have written off the principal.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM CHARLES M. HAMMEL

Q1. As it stands now, banks are able to address the problem of lower-quality assets, concentrated in Latin American countries, through the Allocated Transfer Risk Reserve.

Could that approach be expanded? Should it?

Does the quality of the loans owed to U.S. banks warrant an expansion of the Allocated Transfer Risk Reserve?

Answer 1.

As I indicated in my answer to Senator Heinz's written question 2, expanded ATRRs, in my view, should be considered only when virtually all negotiations between a country and all its lenders, including the IMF and the World Bank, have collapsed. At present, it would appear that the ATRR countries are the ones least likely to enjoy successful debt renegotiations. As far as the quality of the loans is concerned, virtually any sovereign credit to a nation, regardless of the actual sovereign agency recorded as borrower, should enjoy approximately the same credit quality within one nation. Private sector credits within one nation can vary substantially in credit quality. Typically, however, the private sector's access to hard currency through the central bank of a particular country has been uniform, no matter which private sector borrower has applied, so long as it has the local currency to purchase whatever hard currency is available.

Q2. I understand that European banks are characterizing this debt problem as a U.S. bank problem.

How have they arrived at that conclusion?

What impact is their policy of writing down L.D.C. loans having on U.S. banks?

Answer 2.

Selected European banks have characterized the Latin America debt as a U.S. bank problem. They have arrived at this conclusion for two reasons. First, the preponderance of Latin American debt was and is held by U.S. banks. Secondly, several selected European central banks have been forthright in asking their member banks to reserve or writedown Latin debt. As this has happened, the banks have been reluctant to contribute new money which, in turn, they may be asked to write off almost immediately on a formula basis. This could also be an issue as U.S. banks are asked on a country-by-country basis to contribute new money and if our regulators require a percentage writedown in a given country.

2 SASSER--HAMMEL

Q3. In the Joint Economic Committee on June 24th, a witness quoted Helmut Schmitt as saying he felt that Latin American debts are largely uncollectible.

Do you agree with that conclusion?

To the degree that they are, at least in part, collectible, what is preventing the banks from reducing the threat unilaterally, from participating in the Baker Plan?

To the degree that loans are not collectible, what is preventing the banks from recognizing that fact in the computation of the quality of their assets?

Answer 3.

The best chance for the repayment of Latin American debt clearly depends on the ability of the countries and their various borrowers, both private and public sector, to access capital markets. To the extent that the actions taken since August of 1982 will allow for this process, the renegotiations will have been successful at some point in the future. To date, with few exceptions, the capital markets have not reopened to Latin borrowers in any significant way. Collectability is also directly dependent on how long the borrower has to service the debt and at what rate he must service it. If maturities were extended to the 20 or 30 year range, no doubt debt collectability would be significantly enhanced. The practicality of doing so, however, may be questionable.

Q4. How would you characterize the distinction between the implications of "writing off" a loan and "reserving against" a loan?

What role does any distinction have in resolving the problems associated with Latin American debt?

Answer 4.

When a loan is written off, it is usually done so by tapping a reserve. As reserves decline, earnings must be tapped to replenish the reserves. The effect on earnings is, therefore, the same. Writing off a loan, however, can have a negative effect on collection if the borrower discovers that either through regulation or individual bank management decision, the credit has been written off. ATRRs could be damaging to ultimate collection because of the public nature of the ATRR. The effect to income, however, will virtually be the same whether the loan is written off or reserved against.

Q5. Please respond to the estimate that in the next 10 years, one-third of the regional Latin American debt of $380 billion will have to be written off.

3 SASSER--HAMMEL

Answer 5.

It is extremely difficult to predict over a ten-year time span how much Latin American debt might have to be written off. So many variables enter the equation that it is virtually impossible to second guess such things as oil prices, steel exports, U.S. imports, the world economic outlook for inflation, recession, investment, etc.

Q6. According to many estimates, for a free economy to survive, its debt-to-gross domestic product ratio cannot be higher than 25 percent. In the case of Mexico, with a $100 billion debt and a gross domestic product of $175 billion, the ratio is 60 percent. Chile's is at 120 percent, Brazil at 40 to 45 percent. Argentina at 70 percent.

In view of these ratios, the comment was made in testimony yesterday that it is, quote, "The utmost folly," unquote, to be increasing the debt.

How would you respond to that?

Does increasing debtor nations' debt actually contribute to their credit-worthiness?

Answer 6.

Increasing the debt level of debtor nations may contribute to improved creditworthiness to the extent that new debt is used to increase the country's productivity, generating growth in GNP and export earnings and contributing to a reduced debt to gross domestic product ratio.

Q7. What kind of innovations have you seen among debtor nations for stemming capital flight?

I'm interested in your assessment of, for example, debt-equity swaps, financial investment structures, and other initiatives designed to reduce debtors' need for new loans.

What recommendations have you made, and what would you like to see done?

Answer 7.

Capital flight is difficult to control so long as people are willing to pay the asking price for hard currency in local black markets. The best way to control it is to impose strict penalties for dealing in the unofficial markets. However, debt-equity swaps and financial and investment structures will not necessarily do this. If hard currency at a high exchange rates buys the financial protection that an individual or corporation seeks, it is probably worth the price and will probably continue in the absence of strict penalties. Alternatives alone are not the answer.

4 SASSER--HAMMEL

Q8. **Testimony was received in the Joint Economic Committee this week to the effect that the definition of the problem** is wrong, that we need to get the debt problem "off center stage" and focus on restructuring ... *not* short-term liquidity.

Do you agree that short-term liquidity is a misplaced focus of this debate?

How do you go about restructuring without harming U.S. manufacturing and agriculture?

Answer 8.

The short term liquidity of debtor nations and their borrowers is an obvious concern. Fundamental, long term economic restructuring is also a concern and is what the IMF has attempted to achieve through the implementation of various "adjustment programs" on a country-by-country basis. Unfortunately, things do not always work out as the textbook suggests, and economic adjustment may not be politically or even structurally feasible if key issues such as inflation, production and exports cannot be controlled in the ideal way. Therefore, a balance must be achieved between reasonable short term liquidity and viable long term economic adjustments. There is no guarantee that the international debt situation will not have an effect on the U.S. manufacturing and agricultural sectors. The world markets have changed and we will, no doubt, increasingly become a service-oriented economy, but the services can also be exported as the hard manufactured goods were in record numbers in the early 1970s.

Q9. What is the effect on bank stock prices of acknowledging that the quality of some of the assets associated with lending to these debtor nations has fallen to below par value? Haven't there been recent instances where the prices have actually *risen* in response to a bank's public recognition of reality?

Answer 9.

As I indicated in my earlier testimony on June 25, 1986, the *American Banker* published an issue (Friday, June 20, 1986) analyzing bank stock prices, breaking out money centers versus regional banks. I have not reviewed, bank-by-bank, the effects of LDB debt on stock prices. I think it is fair to say, however, that as bad news is reported on LDC debt, stocks may temporarily fall only to recover as the LDC debt news moves off the newspaper pages. I do not believe that there is necessarily a direct correlation, positive or negative, between LDC loans to total loans and stock prices.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM KARIN LISSAKERS

Q1. Current regulations promulgated by the banking regulators require disclosure of information when exposure to any country exceeds one percent of the reporting institution's assets, or 20 percent of its primary capital, whichever is less. Less detailed information need be disclosed for exposure in the .75 percent to 1 (one) percent range of the reporting institution's assets.

Is this enough information for a valid market assessment of bank exposure? Is it freely available to investors? Wouldn't more detailed disclosure requirements provide greater market discipline? What are the disadvantages, if any, to increased disclosure requirements?

A1. a. Existing disclosure requirements for traditional forms of credit risk vis a vis foreign countries are probably adequate -- although investors have to go through the nuisance of applying to the bank regulators for certain details. Why not require banks to include the details in their annual reports?

b. The Committee may want to consider whether current disclosure requirements provide sufficient coverage of off-balance sheet and contingent risks -- Note Issuance Facilities, interest rate and currency swaps, etc. -- that are a rapidly growing part of the international banking business. Banks may be taking on considerable risk that does not show up on the balance sheet and hence is not disclosed under the "one percent rule".

Q2. The issue of capital adequacy for banks with substantial LDC debt exposure was raised at the hearing. U.S. banks have now accumulated $105B of total capital, but it is not clear that those with heavy LDC exposure are better capitalized. Imposition of special reserves (ATRRs) by regulators has been very limited. Only $2.4B of ATRRs have been established against the $90B of LDC debt held by U.S. banks that is rated as troubled (in the OTRP category or below). The above numbers argue for stronger reserve positions and higher capital requirements for banks with heavy exposure to troubled LDC debtors than for other banks.

Have you seen any evidence that banks are setting aside substantial reserves for LDC debt outside of the special reserves required by the regulators? Do you believe that an expanded use of ATRRs is appropriate? In your estimation, do you think banks are holding back in reserving where they think regulators may impose ATRRs?

A2. General loan loss reserves have risen steadily in the last two years when measured as a ratio of LDC loan exposure. But of course these reserves are for all losses, and a host of domestic loan problems have cropped up in this period that are a potential claim against the reserve. Hence the build-up, while positive, is not dramatic when viewed against the totality of problem loans, foreign and domestic.

As I said in my testimony, I favor greater use of the ATRR. First, unlike the general loan loss reserve, this reserve may not be counted as capital, i.e. as a base for further leveraging of the bank, Second, the ATRR forces banks to write down the loan being reserved against. Greater use of the ATRR, in the context of Mexico or Chile, for example, would obviously require US policymakers to abandon the current debt strategy of asking creditors to lend still more money to troubled debtors and move toward a solution that calls for some writing off of loans.

Q3. Some have suggested that the only way to resolve the LDC debt problem is for banks to grant a certain degree of debt forgiveness -- to develop some procedure similar to our bankruptcy statutes. However, Chairman Volcker has voiced strong opposition to debt forgiveness of any kind, claiming that only a few countries in "deepest Africa" are currently unable to meet their debt service obligations.

Four years into the debt problem, is it your belief that all but a few LDC debt borrowers can and will service their loans in a timely fashion? To what extent is the decision of the banks thus far not to reorganize LDC debt as with a failed corporation driven by their focus, and the market's focus, on current earnings as the almost exclusive measure of their health? To what extent is it a regulatory issue? How would the market likely view a one-time accurate revaluation of a bank's LDC portfolio?

A3. I don't think that quarterly reporting requirements or other regulations account for the reluctance of many banks to recognize the bankruptcy of some of the their LDC borrowers -- after all, the same rules apply to domestic bankruptcies and restructurings. It comes down to a question of alternatives and costs. So long as the banks think that the IMF and various government institutions will supply enough marginal credit to the debtors to keep them paying interest to the banks, there is little incentive for the banks with very large exposures to take their losses.

I am not an expert on the stock market. But is does appear that the market is willing to pay a premium for banks with "clean" balance sheets. That is, since 1982, regional banks with small foreign loan exposures have enjoyed a much better price/ earnings ratio than the money-center banks with large exposures. One may therfore surmise that the market, over time, would welcome a realistic valuation of the big banks'foreign loan portfolios.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM
KARIN LISSAKERS

Q1. As it stands now, banks are able to address the problem of lower-quality assets, concentrated in Latin American countries, through the Allocated Transfer Risk Reserve.

Could that approach be expanded? Should it?

Does the quality of the loans owed to U.S. banks warrant an expansion of the Allocated Transfer Risk Reserve?

A1. Please see my testimony and answer to Senator Heinz's second question.

Q2. I understand that European banks are characterizing this debt problem as a U.S. bank problem.

How have they arrived at that conclusion?

What impact is their policy of writing down L.D.C. loans having on U.S. banks?

A2. By nationality, US banks have the largest exposure in Latin America. Latin America is also far more important politically, to the US than to Europe. Hence it is the European position that it is up to the United States to take the lead in finding a solution. Finally, it appears that the European banks, and to a lesser extent the British, have written down substantial proportions of their Latin loans already. They therefore feel freer to walk away from the situation. Any payments they receive in future will appear as extraordinary profits rather than as anticipated earnings.

One clear consequence for US banks is that European banks are increasingly reluctant to participate in further "forced lending" exercises for countries like Mexico. Since European banks have already taken their losses, they have little reason to take on new exposure.

Q3. In the Joint Economic Committee on June 24th, a witness quoted Helmut Schmitt as saying he felt that Latin American debts are largely uncollectible.

Do you agree with that conclusion?

To the degree that they are, at least in part, collectible, what is preventing the banks from reducing the threat unilaterally, from participating in the Baker Plan?

To the degree that loans are not collectible, what is preventing the banks from recognizing that fact in the computation of the quality of their assets?

A3. I agree with the assessment that many of these loans are uncollectable. We will see int he case of Mexico whether banks are still willing to put up new loans in order to keep the old ones performing.

Banks have in fact written off a substantial chunk of private sector loans to Latin America, when the borrower has gone bankrupt. But as Walter Wriston is fond of saying, government don't go bankrupt, i.e. they don't cease to exist and a nation's assets are not liquidated. There is always at least a theoretical possibility that someday the country will pay. Where loans to the public sector are concerned, banks apparently believe that the industrial country governments will hold things together so that the banks can avoid large losses.. (Banks have worked very hard to convert their private sector loans into public sector loans for this reason.)

Q4. How would you characterize the distinction between the implications of "writing off" a loan and "reserving against" a loan?

What role does any distinction have in resolving the problems associated with Latin American debt?

A4. When a bank reserves against possible losses, it provides a cushion against such losses (which can be used to leverage new loans since reserves are considered capital for capital adequacy purposes) but continues to carry the loan at full face value. A write-off means recognizing a loss and reducing the value of the asset.

A bank's decision does not necessarily affect the borrower: The borrower remains contractually bound to repay a loan even after a bank has written it off, unless there is an agreement with the lender to void the contract. A bank that has written down or off an asset will, however, be more willing to contemplate interest concessions or forgiveness than is a bank still carrying the loan at full value.

Q5. Please respond to the estimate that in the next 10 years, one-third of the regional Latin American debt of $380 billion will have to be written off.

Q6. According to many estimates, for a free economy to survive, its debt-to-gross domestic product ratio cannot be higher than 25 percent. In the case of Mexico, with a $100 billion debt and a gross domestic product of $175 billion, the ratio is 60 percent. Chile's is at 120 percent, Brazil at 40 to 45 percent. Argentina at 70 percent.

In view of these ratios, the comment was made in testimony yesterday that it is, quote, "The utmost folly," unquote, to be increasing the debt.

How would you respond to that?

Does increasing debtor nations' debt actually contribute to their credit-worthiness?

A5-6. There are too many unpredictable variables involved to say what is the "correct" ratio of debt to GNP or to say that X percent of a country's debts will inevitably have to be written off.

What one can say, is that for many countries the debt servicing burden is so large that current investment and future growth are having to be sacrificed to support it. Consequently, these countries are becoming economically weaker, not stronger, and less, not more, creditworthy. And even coutries like Brazil, that are servicing their debts without extreme hardship at the moment, remain vulnerable to adverse changes in external economic conditions, eg. dollar interest rates, industrial country growth rates, protectionism, world commodity prices.

At best, the existing debt burden constitutes a substantial drag on the world economy and an element of uncertainty that is unhealthy for creditor and debtor alike. In certain cases, it would make more sense to offer relief throught debt forgiveness or postponement with reduced interest than to add new loans to old. Converting debt to some form of equity or low interest, long term investment instrument would accomplish the same objective, of reducing debt servicing costs and introducing an element of certainty about the future costs..

Q7. What kind of innovations have you seen among debtor nations for stemming capital flight?

I'm interested in your assessment of, for example, debt-equity swaps, financial investment structures, and other initiatives designed to reduce debtors' need for new loans.

What recommendations have you made, and what would you like to see done?

A7. The primary and most effective technique for stemming capital flight has been to drive up domestic interest rates and/or to index investment instruments to the exchange rates. These may stem capital flight, but obviously create other serious problems for the government and economy in question. Sky-high interest rates may keep money at home, tied up in financial instruments, but discourage the kind of long-term investment in productive capacity the debtor economies need to grow out of their problems. High interest rates also worsen the budget deficit problems of the debtor governments.

Q8. Testimony was received in the Joint Economic Committee this week to the effect that the definition of the problem is wrong, that we need to get the debt problem "off center stage" and focus on restructuring ... not short-term liquidity.

Do you agree that short-term liquidity is a misplaced focus of this debate?

How do you go about restructuring without harming U.S. manufacturing and agriculture?

A8. The current approach to the debt problem has been a disaster for US manufacturing and agricultural interests because it has forced debtors to slash imports and step up exports in competition with our producers.

A debt strategy that concentrates on reducing the debt servicing burden and on shrinking the outstanding debt to eliminate some of the uncertainty about the future economic prospects of the debtor countries would encourage investment and expansion in the debtor countries to the direct benefit of our own producers and exporter.

Q9. What is the effect on bank stock prices of acknowledging that the quality of some of the assets associated with lending to these debtor nations has fallen to below par value? Haven't there been recent instances where the prices have actually risen in response to a bank's public recognition of reality?

A9. See my answer to Senator Heinz's third question.